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1991 1992 1993 1994 1995 1996 **1997** ANNUAL REPORT

CANADIAN PACIFIC RAILWAY COMPANY

CANADIAN PACIFIC RAILWAY COMPANY, BASED IN CALGARY, ALBERTA, IS A WHOLLY-OWNED SUBSIDIARY OF CANADIAN PACIFIC LIMITED, WITH ASSETS OF $7.8 BILLION.

TOGETHER WITH SUBSIDIARIES THAT IT OWNS DIRECTLY OR INDIRECTLY, CANADIAN PACIFIC RAILWAY COMPANY PROVIDES RAIL TRANSPORTATION SERVICES OVER A NETWORK REACHING MOST OF THE PRINCIPAL CENTRES OF CANADA, AS WELL AS 16 STATES IN THE U.S. MIDWEST AND NORTHEAST.

THE COMPANY'S TRANSPORTATION SERVICES ACROSS NORTH AMERICA ARE MARKETED UNDER THE NAME CANADIAN PACIFIC RAILWAY. THESE COMPRISE THE SERVICES PROVIDED OVER THE NETWORK OF CANADIAN PACIFIC RAILWAY COMPANY AND ITS SUBSIDIARY COMPANIES, ST. LAWRENCE AND HUDSON RAILWAY COMPANY LIMITED, SOO LINE CORPORATION, AND DELAWARE AND HUDSON RAILWAY COMPANY, INC.

CANADIAN PACIFIC LIMITED COMMON SHARES ARE LISTED ON THE NEW YORK, MONTREAL, TORONTO, VANCOUVER AND ALBERTA STOCK EXCHANGES.

CANADIAN PACIFIC LIMITED'S ANNUAL REPORT IS AVAILABLE FROM THE: VICE-PRESIDENT LAW AND CORPORATE SECRETARY, ROOM 234, WINDSOR STATION, P.O. BOX 6042, STATION CENTRE-VILLE, MONTREAL, QUEBEC H3C 3E4.

January: 1997 opens with a winter onslaught that delivers three years' worth of snow, blizzards and avalanches in one. A quick-recovery plan is set in motion to clear a freight backlog and get CPR back on target for a second consecutive year of substantially improved financial and operating results.

THE LOGO A SENSE OF HISTORY AND LONGEVITY, CANADIAN HERITAGE, THE NOTION OF TEAMWORK, THE STRENGTH OF THE RAILWAY AND ITS NETWORK. **CANADIAN PACIFIC RAILWAY** THE NAME IS WELL RECOGNIZED AND RESPECTED AROUND THE WORLD. A MOVE AWAY FROM THE CP RAIL SYSTEM WORD MARK ALLOWS THE COMPANY'S HERITAGE TO BE FULLY EXPLORED AND PROVIDES AN INTERNATIONAL CLARIFICATION. **THE CIRCLE** REPRESENTS THE WHEEL OF THE LOCOMOTIVE AND THE RAILWAY'S HISTORICAL ROLE IN UNITING CANADA FROM COAST TO COAST. **THE BEAVER** SYMBOLIZES TEAMWORK WITHIN THE RAILWAY AND THE QUALITIES OF INDUSTRIOUSNESS, ENERGY AND SINGLE-MINDED DETERMINATION THAT ARE REQUIRED TO ACHIEVE A COMMON GOAL. **THE SHIELD** SYMBOLIZES A SENSE OF STRENGTH, RELIABILITY, AGGRESSIVENESS AND COMPETITIVENESS. **THE MAPLE LEAF** INTERNATIONALLY RECOGNIZED SYMBOL OF CANADA, IT DEMONSTRATES THE RAILWAY'S PRIDE IN ITS CANADIAN HERITAGE. **1881** SPEAKS TO THE COMPANY'S BIRTH AND ITS LONGEVITY.

1881 *The railway lived out its construction years without a logo, using only "Canadian Pacific Railway" in plain block letters as a word mark.*

1886 *With train timetables to run off, a printer rummaged through stocks of standard logos, pulled out a shield and emblazoned "Canadian Pacific Railway" on it. Thus was born CPR's first corporate logo.*

1886-1889 *By the end of 1886, CPR wanted a visual link with Canada. The beaver was added, along with a branch and maple leaves. The change proved intuitive. The beaver and maple leaf would later be officially adopted as Canada's national symbols.*

1889 *The off-the-shelf shield was replaced by a distinctive design and the beaver lost its branch and maple leaves. Through the 1890s, the beaver and the "Canadian Pacific Railway" lettering underwent several discreet mutations.*

1917 *The word "Railway" was dropped for the first time. The beaver and shield were circled by the words "Canadian Pacific" and the maple leaf made a comeback. The new logo made its debut on steam locomotives and freight cars.*

1929-1946 *Expanding business interests called for a new look. The shield remained but the beaver disappeared. Below "Canadian Pacific" was room for the symbol of the Company's different businesses. The railway had a new slogan: "World's Greatest Travel System."*

1946-1949 *Canadian Pacific was spanning the world and wanted to say it. The circle inside the shield remained but the message was new: "Spans the World." Once again, the Company called on its old friend, the beaver. Modern script-style lettering was introduced.*

1949-1959 *Through the Fifties, the beaver and crest appeared on all Canadian Pacific vehicles. The crest was given a simplified form, free of borders and raised points.*

1960-1968 *A modern touch was deemed necessary for the dawn of the Sixties and the "Canadian Pacific" lettering was changed to a contemporary script font.*

1968-1987 *The multimark, signifying direction, global capability and corporate stability, was developed to meet Canadian Pacific's needs as a multi-faceted enterprise. Canadian Pacific Railway became CP Rail. The multimark was dropped in 1987 and the railway used the word marks CP Rail and later, CP Rail System.*

CANADIAN PACIFIC RAILWAY

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February: The recovery plan produces fast results. A February record is set for freight gross ton-miles. It is the first of seven monthly gross ton-mile records that will be set in 1997. Strong Canadian grain and potash volumes drive CPR's record-setting performance.

1997 CANADIAN PACIFIC RAILWAY COMPANY Highlights

(in millions)

	1997	1996
Income items		
Revenues	**$ 3,716.8**	$ 3,559.4
Operating expenses by type		
Compensation and benefits	**1,211.2**	1,298.5
Material and other	**1,111.1**	1,105.7
Fuel	**343.3**	324.4
Depreciation	**249.1**	226.2
Total operating expenses	**$ 2,914.7**	$ 2,954.8
Operating income	**$ 802.1**	$ 604.6
Net income from railway	**$ 466.5**	$ 446.3
Other financial highlights		
Operating ratio	**78.4%**	83.0%
Cash flow from railway	**$ 946.3**	$ 699.9
Additions to properties	**$ 862.9**	$ 567.0
Total railway assets	**$ 7,842.3**	$ 7,268.4
Total assets of company	**$ 7,842.3**	$ 8,337.9
Net debt:equity of railway	**31:69**	42:58
Net debt:equity of company	**31:69**	14:86
Number of active employees		
Average for the year	**20,150**	21,728
Traffic and operating statistics		
Revenue ton-miles *(in billions)*	**105.8**	103.4
Gross ton-miles *(in billions)*	**186.5**	184.0
Revenue tons carried *(in millions)*	**149.0**	149.2
Gross ton-miles per active employee *(in thousands)*	**9,254**	8,470
Miles of road operated at year-end	**15,865**	17,399
Route miles excluding trackage rights and haulage*	**12,136**	14,328
Number of locomotives at year-end (owned and leased)	**1,619**	1,615
Number of freight cars at year-end (owned and leased)	**53,000**	54,000

* Excludes miles of road operated under trackage rights and haulage agreements.

March: The impact of extraordinarily severe weather is felt on the bottom line as the first quarter ends. Compared with first-quarter 1996: revenue is down $36.8 million; operating expenses are down $8.9 million, reflecting stalled freight shipments; operating income is down $27.9 million; the operating ratio rises to 92.5%, from 89.6%.

CANADIAN PACIFIC RAILWAY COMPANY

President's Message

As I reflect on Canadian Pacific Railway, a company whose plant spans almost 16,000 miles, connects two coasts and traverses an international border, it is clear that we are not the business we were just 24 months ago. We are also not yet the business we intend to be. But I am pleased to report that our 1997 results show we are well on our way.

The turning point came in 1996, with its drama of a headquarters move among the largest ever seen in Canada, a wholesale corporate restructuring, a bold administrative downsizing and consolidation, and a top-to-bottom organization rebuild that flattened management layers and focused on execution and cost.

The results were swift and substantial. Operating income in 1996 – Year One of our rebuilding plan – increased 35 per cent. Our challenge going into 1997 was to build on that momentum. We met that challenge and in the process succeeded in opening up the throttle a few more notches. The first full year in our consolidated headquarters in Calgary, 1997 saw CPR continue to improve financial results while rebuilding and revitalizing assets that are critical to improving service levels and reducing expenses.

Overall, we are on target to achieve by the end of the decade earnings that will consistently generate cash flow above replacement capital expenditures, and to earn returns that compare favourably with North American railway industry averages. This objective reflects the cold reality that, despite regulatory and taxation policies that impose distinct economic and marketplace disadvantages on Canadian railways vis-a-vis their U.S. counterparts, our performance is judged on a North American basis.

The overdue step was taken in 1997 to report CPR's consolidated financial results on a basis more comparable with other North American railways. Our use of this reporting basis enables the capital markets to better compare the financial and operating performance of CPR against that of other major railways. At the same time, our employees can more accurately measure their performance against that of the competition.

April: The biggest transaction in CPR's network rationalization plan is completed. The Washington Organization buys 1,143 miles of lines between Chicago and Kansas City and in southern Minnesota and northern Iowa. Proceeds are used to purchase strategic assets. CPR acquires a one-third equity interest in I&M Rail Link, the company formed to operate the lines.

Excluding unusual items, operating income in 1997 was $80 million higher than in 1996, and $220 million higher than in 1995, when we put in place plans to transform our business. The operating ratio improved two percentage points in 1997, bringing the aggregate improvement to six percentage points since 1995. We are closing on our goal of achieving levels competitive with the U.S. industry average.

Freight revenue in 1997 was $50 million higher than in 1996 despite a winter of record cold, snowfall and avalanches that severely hampered operations on the Western lines, which handle most of our high-volume bulk traffic, spring floods that closed lines between Winnipeg and St. Paul, and revenue forgone from the sale of almost 1,200 miles of lines in the U.S. Midwest.

Capital investment surpassed $850 million in 1997, a record level, funded as planned from cash flow and proceeds from asset sales. Our strategy is to divest assets that do not provide an acceptable return or are not essential for our rebuilding plan, and to reinvest the proceeds in areas that are critical to reducing expenses and improving transportation service.

We achieved in 1997 the biggest single-year progress in rationalizing the track network. More than 2,000 miles of lines were sold, leased or discontinued, and a 150-mile line was transferred to an internal shortline that can be operated at lower cost and, consequently, become viable. Proceeds from the sale of lines and real estate exceeded $450 million in 1997, generating cash for reinvestment in strategic assets, including commercial facilities, high-volume track corridors and high-performance locomotives employing the most progressive locomotive technology available.

Our investment in locomotives will bring the average age of CPR's fleet to just under 16 years by the end of 1999, compared with 23 years at the beginning of 1997. CPR will have the highest proportion of high-adhesion alternating current locomotives of any major railway fleet in North America.

Pivotal in 1997 was our decision to remain a transcontinental carrier on the strength of continued progress in turning around the struggling eastern network. The St. Lawrence and Hudson Railway Company Limited (StL&H), established as a subsidiary in 1996 to own and operate the eastern assets,

May: Negotiations begin with Genesee Rail-One to lease the 181-mile CPR line between Sudbury and Sault Ste. Marie in northern Ontario, setting the stage for a July takeover. Six months later, Genesee Rail-One adds a second CPR line to its holdings when it purchases the 354-mile corridor linking Quebec City, Montreal and Hull.

achieved positive cash flow in 1997, its first full year of operation. The StL&H has used its greater flexibility as a regional carrier to develop a lower cost structure and to introduce the operating improvements and innovative service technology that are required to succeed in the hyper-competitive eastern market.

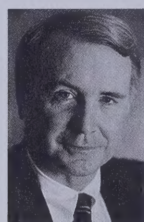
Critical to our fortunes in the East were 11th-hour agreements with Norfolk Southern (NS) and CSX giving the StL&H commercial access to the important markets of New York City, Buffalo, New Jersey and Philadelphia. The settlements were reached only hours before the deadline set by regulators for filing objections to an application by NS and CSX to control Conrail. They finally address long-standing limitations to market access on our Northeastern lines, opening up the potential for market growth.

Earlier in the year, we reached a reciprocal haulage-rights agreement with NS that also offers opportunities for growth. StL&H will receive haulage rights over a shorter route for freight moving into the U.S. from Quebec and Ontario, as well as trackage rights that will improve service to Philadelphia. NS will obtain haulage rights that will improve its service to New England and Canada. The agreement is conditional on regulators approving the application to control Conrail.

Improvements to the track network in the U.S. Northeast since 1990 that have allowed higher train speed, coupled with this expanded access into most of the region's largest markets, give the StL&H the means to grow freight volumes in profitable business segments.

New labour agreements in 1997 introduced breakthrough concepts and opened the door to a relationship based on mutual benefit. For the first time in Canada, unionized railway employees agreed to gain-sharing programs under which they can receive additional compensation based on work productivity. The new provisions – included in contracts with three unions representing about half the unionized workforce – provide opportunities to further reduce expenses, and at the same time reward those most directly responsible for the gains. Equally important, they offer employees a concrete way to appreciate their individual role in the business. The provisions recognize that the best job stability – for labour and management – lies in business growth and profitability.

June: The second quarter ends with improved performance over 1996. Excluding unusual gains, quarterly revenues are up $18.5 million on the strength of Canadian grain, potash and intermodal traffic; operating expenses are down $7.9 million despite higher freight volumes; operating income is up $26.4 million; the operating ratio improves to 81.1%, from 83.8%.



As we move ahead, old citadels of tradition are being knocked down. Work processes and operating procedures that are rooted in what CPR was, not what it has to be, are being replaced. Information access, once hindered by outmoded systems, is expanding in a way that is allowing us to manage the business more effectively. These changes, which have as their foundation a new generation of information systems, are giving us the means to provide more innovative transportation products and higher-quality service – all at lower cost.

We are also embarking on a new era of team-building not just within CPR, but with unions, customers, suppliers and an expanding field of partner railways led by the growth of shortlines and regionals, some operating on former CPR trackage.

Progress in 1997 was rewarding. We moved substantially closer to becoming the business we intend to be: low-cost, efficient and effective as judged against peer railways; consistently achieving service levels that generate customer satisfaction; turning satisfaction into profitable growth in freight traffic and the capacity to meet our reinvestment needs internally.

The qualities required to achieve this progress are embodied in the symbols that form CPR's new corporate identity, launched in 1997 and embossed in the cover of this annual report. The beaver symbolizes teamwork, energy and single-minded strength of purpose. The shield symbolizes strength, reliability and competitiveness. They represent the modern-day attributes needed for success. They speak volumes about the company we are today – and intend to be tomorrow. The 20,000 people across the railway can take pride in what our new identity implies and in the accomplishments of 1997.

R J Ritchie

R.J. Ritchie

President and
Chief Executive Officer

A new era of

team-building

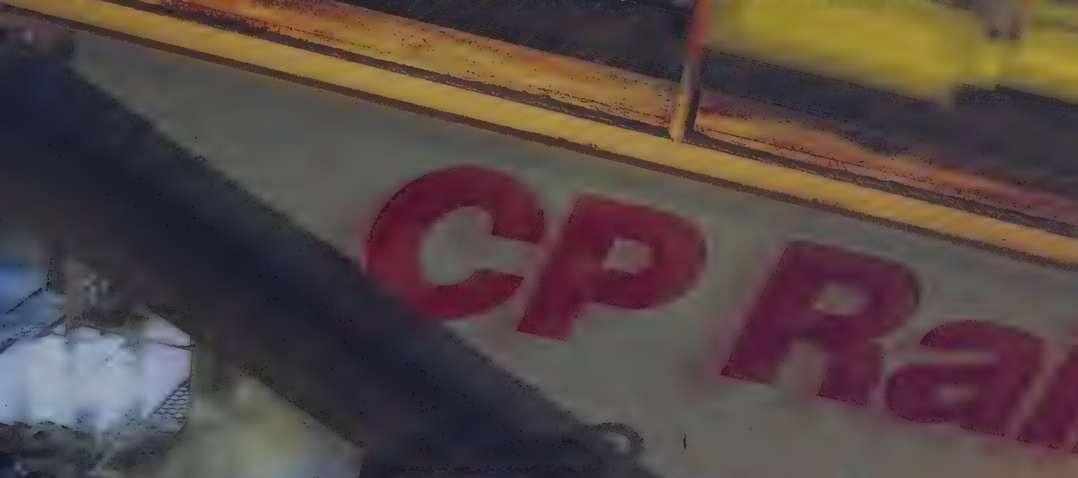
within CPR and with

unions, customers, suppliers and partner railways.

GREG ANDERSON, GENERAL MANAGER, AUTOMOTIVE LINE OF BUSINE
AND PAM WEIGEL, MARKETING ANALYST, CHEMICALS AND ENERGY

CPR emerged from 1997 a stronger company in all respects. Among its greatest strengths are its people. New talent has emerged to meet the challenges of rebuilding. Employees have been the drivers of a new style of decision-making that is taking hold.

CPR is investing in assets that improve service and provide capacity for growth. The locomotive fleet is being recharged with 262 high-capacity units employing the most advanced locomotive technology available. Service reliability is particularly critical in the intermodal market, another major area of investment.



SHUTTLE TRUCK TAKES CONTAINER FROM DOCKSIDE TO CPR TRAIN AT DELTAPORT TERMINAL NEAR VANCOUVER. NEW LOCOMOTIVES AT GENERAL ELECTRIC, ERIE, PENNSYLVANIA.

Under long-term agreement, CPR is moving all production from IMC Kalium's giant potash mine at Esterhazy, Saskatchewan. CPR is the leading transporter of potash in North America, and moved record volumes in 1997.

WORKING A MILE BELOW THE SURFACE, MINERS EXTRACT POTASH AT ESTERHAZY, SASKATCHEWAN.

NEXT PAGE: Track infrastructure is being upgraded to allow for faster, heavier trains. FROM TOP: Potash moves to U.S. and export markets; high-capacity grain cars are loaded at AgPro elevator in Moose Jaw, Saskatchewan; and light-weight aluminum coal cars are tested for opportunities to increase tonnages without increasing operating costs.

HIGHER VOLUMES OF GRAIN, COAL AND POTASH DROVE UP REVENUES IN 1997.

NETWORK MANAGEMENT CENTRE DIRECTORS DAN WINISKI (LEFT) AND ROB WEIR REVIEW OPERATING PLANS

TOP: The Network Management Centre in Calgary is CPR's hub for co-ordinating and delivering freight service. Operations and Commercial teams sit side by side to ensure customer commitments are fed directly into service planning.

BOTTOM: Ottawa Valley RaiLink is among the expanding field of partner railways operating on former CPR lines that gain new vitality and viability as shortlines.

Iron Highway, a radically new form of trailers-on-train technology employing fast drive-on/drive-off features, proves itself after a year of in-service trials between Montreal and Toronto. For the first time, the railway has an opportunity to convert trucks from competitors to customers in the short-haul market.

IRON HIGHWAY WILL BE EXPANDED IN 1998 WITH NEW EQUIPMENT AND A TERMINAL NEAR TORONTO.

NEW HIGH-CAPACITY AC LOCOMOTIVE LEADS TRAIN OUT OF CPR'S ALYTH YARD IN CALGARY

CPR won the Canadian Information Productivity Award in 1997 for developing a radio-frequency technology that improves the way train movements are planned and tracked.

July: Train crew employees in Canada ratify a contract that introduces a breakthrough gain-sharing plan, a new method of pay and more flexibility in work rules, and freezes basic pay for a year. For the first time, crews are paid on the basis of miles run, rather than a combination of mileage and time on duty, and can share directly in the benefits of the productivity gains they help achieve.

CANADIAN PACIFIC RAILWAY COMPANY

1997 Overview

For the second consecutive year, Canadian Pacific Railway achieved a substantially improved level of operating profitability, earned higher profit margins and returns on capital, and increased cash flow.

By virtually all measures, 1997 was a year of substantial progress, initiated in 1996 with aggressive action that saw the railway's organization taken apart and rebuilt component by component to become lower-cost and more effective, and to achieve the financial results that would allow us to quickly revitalize strategic assets. Nineteen ninety-seven was the first full year under the new organization, and the first year by which the full impact of our rebuilding effort could be judged.

Results faltered in the first quarter under the weight of a winter that dropped three years' worth of blizzards, avalanches and freezing temperatures in one. CPR recovered quickly, gaining momentum quarter after quarter through the remainder of 1997, and posting seven monthly records for freight gross ton-miles in ongoing operations. By year end, the accumulated results proved the first quarter to be a temporary – albeit difficult – setback. Excluding unusual items, operating income reached a record $668 million in 1997, up $80 million, or 14 per cent over 1996. Expenses fell to $2,915 million in 1997, a drop of $40 million from 1996. In the past two years, CPR has achieved ambitious cost-reduction targets, taking a total of about $200 million out of the cost base.

Freight revenues were $3,429 million in 1997, up $50 million from 1996, a particularly strong performance in light of the sale of almost 1,200 miles of track in the U.S. Midwest that generated some $200 million a year in revenue. After adjusting 1996 freight revenues to exclude those forgone as a result of the sale, revenues rose $214 million, or seven per cent over 1996. Excluding unusual items, CPR's operating ratio improved to 81.4 per cent, two percentage points below the level of 1996, a year in which the operating ratio was reduced by four percentage points. Net income for the railway – including a pre-tax non-recurring gain of $134 million from asset disposals – was $467 million in 1997, compared with $446 million in 1996.

August: Plans are in place to begin building a $27.5-million intermodal terminal on 95 acres of land purchased from the City of Calgary. When it opens in 1999, the terminal will expand capacity to handle growing container and trailer traffic, and will accelerate shipments to and from southern Alberta and eastern British Columbia. It will be among the largest of CPR's 24 intermodal terminals.

Driving our improved performance is a five-point corporate strategy that began in 1996 and was pursued relentlessly in 1997:

1 **Quickly renew** assets needed to grow the business or to reduce expenses

2 **Accelerate rationalization** of non-strategic assets

Renew strategic assets: The year began with a capital investment plan of about $700 million, but the figure was later increased to more than $850 million, a record level. The move reflected confidence that our corporate strategy would produce in 1997 the results needed to fund this higher spending from cash flow and proceeds from asset sales, as planned. Investment in 1997 focused largely on renewing locomotive power, track infrastructure, including terminals and right-of-way, and information systems. These components of the business are particularly critical to reducing expenses, improving service and building capacity for business growth.

The additional capital was used to accelerate plans to renew the locomotive fleet with high-horsepower units employing alternating current (AC) technology. Some 90 AC locomotives entered the fleet in 1997, part of an order for 262 to be delivered by the end of 1999 – the largest order ever by a railway in Canada. The locomotives represent a technology change on a scale last seen in the 1950s when CPR undertook its wholesale conversion from steam power to diesel-electric. AC technology produces higher wheel-to-rail adhesion, yielding a hauling capacity almost twice that of CPR's standard road locomotives. AC locomotives are ideally suited to hauling heavy freight over challenging geography and in harsh winter conditions. Service will become more reliable and asset utilization will improve as locomotives spend more time in service generating revenue and less time in repair shops generating expenses.

By the end of 1999, CPR will have renewed fully 40 per cent of its high-horsepower road fleet. We will enter the next millennium with the newest locomotive fleet in Canada and one that is on a par with those of the major railroads in the U.S.

September: The third quarter ends with sharply improved results over 1996. Canadian grain and potash volumes drive up revenue, while a 7% drop in the average number of employees helps reduce expenses significantly. Excluding unusual gains, revenue is up $25.9 million; operating expenses are down $35 million; operating income is up $60.9 million; the operating ratio improves to 76%, from 82.3%.

3 **Continue reducing** operating expenses

4 **Improve customer service** to generate satisfaction levels that translate into profitable growth

5 **Turn around the performance** of the eastern network

Track infrastructure renewal focused on two high-volume corridors in 1997: the Export Corridor between Calgary and Vancouver, and the South Corridor between Moose Jaw and Chicago. Work centred on upgrading signals and trackbed to allow for faster, heavier trains, and installing and expanding sidings to accommodate longer trains and increase corridor capacity. These improvements will enable CPR to take full advantage of the capabilities of AC technology, and the productivity benefits offered by higher-capacity freight cars.

CPR also began building an intermodal freight terminal in Calgary, and continued work on a new terminal in Vancouver. Both will begin operating in 1999, increasing container and trailer capacity by 80,000 units a year. Terminals in Regina, Toronto, Minneapolis and Chicago were expanded and upgraded. Work at the Regina terminal, which handles large volumes of north-south freight, will support renewed efforts to convert U.S. boxcar traffic to containers and trailers that offer greater handling efficiencies and flexibility.

A $50-million, multi-year modernization of Bensenville yard in Chicago, a critical crossroads for U.S. freight, neared completion in 1997. Advanced control technology introduced as part of the upgrade almost doubles the capacity of the yard, our biggest facility in the U.S.

We also continued in 1997 to introduce a new generation of leading-edge computer applications and platforms that will see CPR emerge as an industry leader in exploiting information technology to operate the business. This new technology is providing the foundation CPR needs to develop business and customer-service solutions that make the railway highly competitive and efficient.

October: Agreements are reached with Norfolk Southern and CSX giving the St. Lawrence and Hudson Railway commercial access to New York City, Buffalo, New Jersey and Philadelphia, as well as other smaller areas in the U.S. Northeast. There is new potential for market growth as the StL&H, CPR's eastern subsidiary, now has access to most of the largest markets on the Eastern Seaboard.

Advances are being made in planning and tracking train and individual car movements, automating the entry and dispatch of trains in and out of yards, and making shipment location available to customers on a real-time basis at their own office workstations. New on-line price quotation systems are making marketers more responsive. Shipper orders for freight equipment and service are being processed faster, improving train planning and asset management. CPR's information services will be increasingly integrated with those of customers in all industries, particularly grain – our biggest single source of revenue.

More improvement is coming from additional information-based initiatives that were launched in 1997. These are providing the foundation for quickly building more efficiency into key activities, including maintaining locomotives, cars and track, and procuring materials and services, which account for about half of CPR's total annual operating and capital expenditures. Redesigned financial, human resource and cost- and price-management systems are widening access within CPR to business data, an important improvement in an organization that is relying more on cross-functional activity to get work done and driving decision-making down to the levels where it is most effective.

Rationalize non-strategic assets: Track rationalization has accelerated under a new Canadian law that makes the process less burdensome. A three-year plan was announced in August 1996 to divest about 4,400 miles, or 25 per cent of the network, by selling, leasing or discontinuing lines, or establishing low-cost internal shortlines. In 1997, additional plans were announced to rationalize 1,000 miles of Prairie branch lines.

The pace of line rationalization has exceeded expectations. By the end of 1997, almost 3,600 miles of track – two-thirds of the planned total – had been rationalized. Most of the remaining 1,800 miles will be divested in 1998. The biggest transaction was concluded in April when 1,143 miles of lines were sold in the U.S. Midwest.

We intend to achieve a 3,800-mile high-density, high-quality network stretching from Vancouver to Chicago and Toronto, with a seamless connection to CPR's eastern subsidiary, the St. Lawrence and Hudson Railway. This network will be fed by the growing number of new railways operating on former CPR lines that gain new vitality and viability as lower-cost shortline or regional operations. In the last two years alone, six new shortlines and one regional railway have been established on lines leased or purchased from CPR, and two internal shortlines have been created.

Repair facilities in Sudbury and Winnipeg were closed in 1997 and the work was consolidated at shops in Thunder Bay and Calgary. In the past four years, nine repair shops have been closed, as growing investment in new power and freight cars reduced in-shop time, and better equipment and procedures increased shop productivity.

November: The largest order of locomotives ever by a Canadian railway is announced. CPR will acquire 262 new advanced traction locomotives by the end of 1999. The average age of the locomotive fleet will fall to 16 years, from 23 years, and fully 40% of the high-horsepower road fleet will be renewed. Locomotive utilization and service reliability will improve.

Sales and monetization of non-strategic properties continued to generate capital for investment. These included the monetization of CPR's interest in a lease on land occupied by the Molson Centre in Montreal, a transaction that generated proceeds of about $50 million.

Reduce operating expenses: A 25-per-cent cut in administrative staff and associated programs – initiated in 1996 to take $100 million a year out of the cost base – produced the intended results in 1997, the first full year in our slimmer suit.

Benefits were achieved in collective bargaining agreements reached at mid-year with half of the unionized workforce in Canada. The settlements – with unions representing train crews, clerical workers and communications and signal maintainers – produced increased work-rule flexibility and introduced a breakthrough gain-sharing plan. For the first time, unionized employees can share directly in the benefits of the productivity improvements they help achieve. The agreement with train crews also provides for a simplified pay method based on miles run, rather than a combination of mileage and time on duty, and a one-year pay freeze. The new contracts expire at the end of 1998. Negotiations are continuing with unions in Canada representing shop workers, track maintainers, rail traffic controllers and security officers.

Agreements providing for increased work-rule flexibility have been reached with 10 of 16 bargaining units on the Soo Line and two of 15 units on the Delaware and Hudson, our subsidiary railways in the U.S. On the Soo Line, where two-thirds of unionized employees now have renewed agreements, several settlements also introduce formal processes by which union and management can jointly examine opportunities to increase productivity. On the D&H, the agreement with shopcraft workers is subject to ratification and the agreement with locomotive engineers eliminates pay for time on duty, introducing a flat-rate pay per trip and rate increases linked to productivity improvements. Negotiations are continuing with the remaining bargaining units.

Improve service for business growth: Our business begins with the customer and ends with the customer's customer. The surest way to business growth and sustained profitability is to provide a quality of service that creates value at both ends of the chain. In 1997, we launched a sweeping project to review all the processes involved in providing freight service, and to rebuild with a focus fixed on improving the quality of our transportation products and reliability of our service.

Service Excellence will implement new or enhanced processes all along the transportation chain, supported by the new generation of computer applications and platforms being introduced. As Service Excellence builds through 1998, it will bring improved performance in an area that is critical to the success of the business: consistent, on-time delivery of our customers' freight. In the process, we will also achieve higher asset productivity. This will maximize the benefits from investment in such assets as locomotives, freight cars, track and terminals, which are key to improving service and achieving business growth.

December: The final quarter sees three consecutive monthly records set for freight gross ton-miles. Excluding unusual gains, revenue increases $32.2 million over fourth-quarter 1996; expenses are up $11.7 million, reflecting heavy freight volumes; operating income is up $20.5 million; the operating ratio improves to 77%, from 78.4%.

Service quality is crucial to developing strong partnerships with connecting carriers, which interchange more than $1 billion in freight with CPR annually. In 1997, we began an interline business initiative to learn from the largest connecting carriers what CPR can do to become their partner of choice on interline shipments.

After a year of successful in-service trials, we decided to expand a radically new form of intermodal train technology that for the first time gives the railway an opportunity to convert trucks from competitors to customers in the short-haul market. Called Iron Highway, trucks drive on and off a continuous-platform train that has remarkably smooth handling characteristics. Operating in the road-dominant Montreal-Toronto corridor, it gives truck companies an alternative to congested highways. Truckers can reserve space on a next-departure basis and be assured freight will arrive when their customers are expecting it, regardless of road conditions.

In the cross-border market, CPR forged unique electronic customs-clearance links with U.S. and Canadian customs agencies and brokers to expedite intermodal freight. Together with upgraded and expanded intermodal terminals, this improvement puts CPR a step ahead of the competition. Fast customs clearance will be an important asset for gaining market share in the highly-competitive intermodal corridor between the West Coast and Chicago.

The Port of Vancouver's new container terminal, Deltaport, opened in October. It expands opportunities for CPR to handle intermodal freight moving between Asia and the U.S. Midwest and Eastern Seaboard. Offshore, CPR opened an office in Beijing, becoming the first foreign railway to have a permanent commercial presence in the People's Republic of China and creating a valuable foothold in the world's most populous country and one of its fastest-growing economies. The move led to an agreement between CPR and the China Railway Container Transport Centre to co-operate on issues related to inland rail tariffs.

In December, CPR applied for regulatory approval to build an eight-mile rail line to Union Carbide Canada's planned polyethylene plant in southern Alberta. The line would give Union Carbide a link to CPR's network, which offers more than twice as many direct rail connections to the U.S. as any other Canadian railway, as well as direct access to Canadian and export markets.

In the grain industry – CPR's biggest source of revenue – elevator companies continued to consolidate grain pick-up points by building high-throughput facilities that can store vast amounts of grain, load cars quickly and accommodate longer trains. These facilities present opportunities for improving efficiency in the grain handling and transportation industry, especially in the increased utilization of grain cars and locomotives.

December: Record capital investment of about $1 billion is announced for 1998, as CPR continues its aggressive asset rebuilding program. Leading areas of investment: high-horsepower locomotives, track infrastructure, commercial facilities and leading-edge information systems – all critical to reducing expenses, improving service and building capacity for business growth.

In a promising development, the federal government announced in late 1997 that a regulatory review of Canada's grain handling and transportation system would begin immediately in 1998, instead of 1999 as originally scheduled. The review will focus on recommending ways to ensure an efficient, viable and competitive system in which there are clear roles, responsibilities and accountabilities for all participants, including railways, farmers and wheat pools. The review is urgently needed. Canada must have a more market-driven, less complicated and less regulated system to remain a strong world competitor.

Improve the eastern network: A year ago, the future of CPR's struggling Eastern operations was uncertain. Cash flow languished at inadequate levels in the region, where trucks dominate the market. In the 12 months that followed, the uncertainty was lifted. Our move in 1996 to transfer all eastern assets into a new subsidiary railway, the St. Lawrence and Hudson, produced substantial results in 1997. The StL&H has used its greater flexibility as a smaller, regional railway to develop a lower cost structure and to be highly responsive in a marketplace that demands it.

The StL&H corridor linking Montreal, Toronto, Windsor and Chicago offers value as a strong competitor in the region and as a feeder for traffic on our Western lines. There is also new opportunity for growth in the StL&H corridor into the U.S. Northeast. Agreements reached in 1997 with Norfolk Southern and CSX give the StL&H commercial access to New York City, Buffalo, New Jersey and Philadelphia, as well as other smaller areas in the Northeast. The StL&H now has access to most of the largest markets on the Eastern Seaboard.

CPR must continue to make progress in creating value for employees, customers, its ultimate shareholders and investors. In 1998, we will invest about $1 billion – an unprecedented amount – to continue our aggressive asset rebuilding program. We must also achieve the financial results required to continue funding this rebuilding, and the operating results to generate an attractive return on capital employed.

It won't happen overnight. But it will happen, day after day, month after month, quarter after quarter. Team CPR has demonstrated over the past two years that it has the spirit, the know-how and the staying power to make sustained progress.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Change in accounting

Beginning in 1997, the Company changed its financial reporting practices to show consolidated results on a basis more consistent with Class 1 railroads in the U.S.

The change will help investors to make more direct comparisons of the Company's performance with that of other North American railroads.

Although there was no effect on the Company's net cash flow, the impact of the change on the Company's reported profitability was significant. The new reporting basis lowered 1997 reported annual operating revenues by $226 million and operating expenses by $356 million, generating an increase in operating income of $130 million. The corresponding operating ratio improved by 4.5 percentage points. The retroactive application of these changes increased year-end shareholder's equity by $393 million.

The new approach includes capitalizing more track replacement and related costs, netting revenues and expenses for ancillary services and changing the timing of freight revenue recognition. The capitalization policy treats as additions to property all costs of track program work, a portion of which was previously expensed as incurred. The Company also adopted the U.S. practice of netting certain operating expenses and revenues related to low-margin ancillary services, such as interline switching and cartage. While not significant, the timing of recognizing revenues changed from booking revenues on a termination-of-movement basis to booking revenues on a percentage-of-move-completed basis.

All figures reflect the new reporting practices, including previous periods, which have been restated on the new basis, except for the change in revenue recognition, that was not considered material and applied prospectively, commencing in 1997.

1997 performance compared with 1996

(in millions)

	1997	1996	Increase/ (Decrease)
Summarized Consolidated Statement of Earnings			
Revenues	**$ 3,582.5**	$ 3,542.7	$ 39.8
Unusual gains	**134.3**	16.7	117.6
Operating expenses	**2,914.7**	2,954.8	(40.1)
Operating income	**802.1**	604.6	197.5
Interest expense, net	**96.0**	53.6	42.4
Other (income) expenses, net	**44.8**	(47.6)	92.4
Net income before income taxes	**661.3**	598.6	62.7
Income tax expense	**192.4**	110.5	81.9
Net income	**$ 468.9**	$ 488.1	$ (19.2)

In 1997, the Company's operating income totalled $802.1 million, compared with $604.6 million in 1996. Excluding unusual gains, operating income increased to approximately $667.8 million, up $80 million, or 14 per cent over 1996, due to both increased revenues and reduced operating expenses. Excluding unusual gains, the operating ratio improved to 81.4 per cent in 1997, from 83.4 per cent in 1996.

Revenues increased by approximately $40 million over 1996, despite revenues forgone from the sale of the Company's Kansas City and Corn Lines ("KCCL") in April 1997. Excluding these forgone KCCL revenues, total revenues were up $205 million over 1996.

This improvement in revenues from ongoing operations was broad based and due mainly to increased volumes of grain, coal and potash, with steel, cement and automotive traffic contributing to a lesser degree. Canadian grain had the greatest impact as a result of a record 1996/1997 crop year. Potash volumes were spurred by record export movements and new business that formerly moved on competing railways and by truck. Coal shipments were up due to increased U.S. business and favourable operating conditions in the fourth quarter. Intermodal and automotive shipments increased on the strength of positive economic factors and higher automotive imports.

Operating expenses decreased by about $40 million as cost reduction initiatives more than offset overall inflation and the incremental costs incurred in the first quarter because of harsh winter operating conditions. The decreases were widespread. The major contributors to the overall reduction were: the full-year benefit of the corporate reorganization and administrative downsizing initiated in 1996, which significantly reduced labour-related expenses; line rationalizations, which reduced labour and materials expenses; and the acquisition of new locomotives, which reduced maintenance, fuel consumption and equipment rents. The continued strong return performance of the pension fund resulted in lower pension expense, contributing to the overall improvement in expenses.

Unusual gains in 1997 totalled $134 million, up approximately $118 million from 1996. Gains on the sale of the KCCL and rationalization on the St. Lawrence and Hudson Railway contributed $54 million and $42 million, respectively, and the monetization of a property lease in Montreal contributed $38 million.

Adding in the reduced contribution from non-rail operations, the non-recurrence of an unusual gain in other income and higher income tax expense (despite including income tax benefits transferred to affiliates), the resulting net income for the year was $468.9 million, down four per cent from 1996.

The near-term outlook for freight traffic continues to be reasonably strong. The recent turmoil in Asian financial markets could adversely affect the Company's export volumes. However, this should be directionally offset by improved export demand due to the level of the Canadian dollar relative to the U.S. dollar, another strong grain crop and a relatively robust North American economy. With the arrival of 262 new high-traction alternating current ("AC") locomotives between 1997 and 1999, the accelerated renewal of the road fleet will significantly improve service reliability, supporting top-line growth, and will reduce expenses. Lower fuel prices are also expected to have a positive impact on operating expenses in 1998.

1996 performance compared with 1995

(in millions)

	1996	1995*	Increase/ (Decrease)
Summarized Consolidated Statement of Earnings			
Revenues	**$ 3,542.7**	$ 3,560.2	$ (17.5)
Unusual gains	**16.7**	–	16.7
Operating expenses	**2,954.8**	3,112.5	(157.7)
Operating income	**604.6**	447.7	156.9
Interest expense, net	**53.6**	29.3	24.3
Other (income) expenses, net	**(47.6)**	17.4	(65.0)
Net income before income taxes	**598.6**	401.0	197.6
Income tax expense	**110.5**	151.8	(41.3)
Net income	**$ 488.1**	$ 249.2	$ 238.9

* The table above and text below exclude the 1995 restructuring charge of $1,143 million.

The Company's operating income for 1996 was $604.6 million, compared with $447.7 million in 1995, improving the operating ratio, excluding unusual gains, for 1996 to 83.4 per cent, from 87.4 per cent for 1995. The higher operating income in 1996, along with a gain on the partial redemption of 4% Consolidated Debenture Stock and the recognition of tax benefits in the United States, increased the Company's net income to $488.1 million for 1996, $238.9 million higher than in 1995, excluding the after-tax effects of the restructuring charge of $704 million. The improved performance of the Company was essentially cost-driven. Although revenues remained virtually unchanged from those of 1995, operating expenses decreased by $157.7 million.

Freight revenues decreased slightly, from $3,408.6 million in 1995 to $3,379.3 million in 1996. Significant drops in U.S. grain, potash, woodpulp and intermodal shipments were partially offset by increases in Canadian grain and coal. The decline in U.S. grain shipments was due to a late harvest in 1996 and to hold-backs by farmers in anticipation of higher grain prices in 1997. Potash decreases were due to reduced export sales to China. Lower woodpulp revenues and intermodal volumes were mainly the result of the Company's withdrawal from less profitable business. Higher Canadian grain revenues resulted from a record grain crop and increased transportation prices. Increased demand for coal resulted in higher coal revenues.

Largely offsetting the decrease in freight revenues were higher revenues resulting from a gain of $16.7 million on the sale of an equity investment in an industry insurance association and increased real estate sales.

Operating expenses of $2,954.8 million were $157.7 million lower than in 1995. The reduced operating expenses were mostly a result of the 25 per cent administrative downsizing, the acquisition of new locomotives and covered hoppers, and of various other streamlining and consolidation measures. These included curtailment of overtime in train and yard operations, closure and consolidation of rail repair and maintenance shops, and withdrawal from less profitable business. Reductions in charges from joint facilities, property and sales taxes and corporate allocations also contributed to the decrease in operating expenses. Higher fuel prices and increased accruals for employee profit-sharing plans and pension payments partially offset the reductions in operating expenses.

Also affecting net income for 1996 was a gain of $120.4 million on the partial redemption of 4% Consolidated Debenture Stock, which was partially offset by an adjustment to the amortization of the discount on the restructuring accruals of $30 million due to a reduction in the discount rate.

The effects of changing price levels

Inflation rates during the past three years have generally not had a material effect on Canadian Pacific Railway's operating income. However, competitive markets have restrained rate increases while input costs have continued to rise, putting pressure on profit margins. Except for a two per cent rise in 1996, average freight rates have declined over the past few years, necessitating substantial efforts to reduce costs.

Liquidity and capital resources

Operating activities

Cash flow was $946.3 million in 1997, $246.4 million higher than in 1996. The significant improvement was due to increased operating income, asset sales and deferred income tax expense. The latter reflects timing differences between taxable income and reported income. Both years benefited from tax-loss carry-forwards available to the Company to reduce taxable income. However, the Company will likely not have the use of material tax-loss carry-forwards in 1998.

Cash payments related to labour and other restructuring initiatives amounted to $209.4 million in 1997, down slightly from $216.2 million in 1996.

Non-cash working capital, excluding restructuring amounts, decreased by $97.2 million in 1997. The decrease was due mainly to increased accounts payable and the timing and amounts of cash tax payments.

Investing activities

Capital expenditures in 1997 were $862.9 million, an increase of $295.9 million over 1996. The bulk of the increased expenditure was for the acquisition of 90 advanced traction AC locomotives. Accounts payable increased $221.1 million as a result of additions to properties for which payments will be made in 1998.

The Company plans total capital investment in the order of $1 billion in 1998. This record level of investment reflects the Company's strategy to revitalize its core network over the next few years. Included in the investment plans are a major upgrade of the track network, particularly in the Western and Southern corridors, and the accelerated replacement of older locomotives with additional high-horsepower AC units employing the most advanced locomotive technology available.

Concurrently, the Company is engaged in an ambitious effort to identify and realize value on surplus and underperforming properties and on operations ancillary to its core operations. These sources of liquidity, combined with cash on hand at December 31, 1997, and the expected cash flow from operations in 1998, should be sufficient to fund capital investment without material external financing. Nonetheless, the Company is currently exploring opportunities for advantageous external financing of locomotive acquisitions, as these assets offer the potential for particularly low-cost funding. However, even with external financing of the locomotive acquisition program, no material deterioration is expected in the Company's financial leverage.

Proceeds from disposition of transportation properties contributed $451.9 million in 1997, compared with $19.5 million in 1996. The increase was generated largely by the sale of the KCCL in the U.S. and the Trois Rivières-Quebec City-Hull line in Eastern Canada. Additionally, the monetization of the Company's interest in a property lease in Montreal contributed proceeds of about $50 million in 1997. In 1998, some proceeds are expected from additional asset monetizations, but proceeds from disposal of transportation properties are expected to be considerably lower than in 1997.

Balance sheet

The Company's assets totalled $7,842.3 million as at December 31, 1997, reflecting a decline of $495.6 million, or six per cent, compared with assets of $8,337.9 million at the end of 1996. The decline was primarily attributable to the distribution of $1.4 billion of non-rail assets to Canadian Pacific Limited in June 1997. This was partially offset by a net increase in properties of $339 million, reflecting the Company's investing activities as described above.

Financial instruments

Exposure to changes in the Canadian and U.S. dollar exchange rates on future revenue streams and certain U.S. dollar expenditures is managed by selling or purchasing forward U.S. dollars at fixed rates in future periods. As at December 31, 1997, the Company had entered into foreign exchange contracts to sell approximately US$420 million at rates ranging from 1.40 to 1.43 over the 1998-2000 period, and to purchase approximately US$30 million in 1998 at a rate of 1.44.

The Company is party to a number of interest rate swap agreements that convert a portion of its fixed interest rate liability into a variable rate liability. As at December 31, 1997, the Company had outstanding swap agreements for nominal amounts of US$295 million (equivalent to Cdn.$421.9 million) and of Cdn.$37.5 million.

Future trends, commitments and risks

In recent years, the Company has undertaken a range of major initiatives designed to reduce costs and enable it to cope with moderate growth and underutilized rail lines generating modest financial performance. Major provisions and asset write-downs were recorded in recent years related to rationalization of the track network and facilities and to other cost-reduction initiatives that resulted in substantial workforce reductions.

Most of the Company's 1998 capital investment will be for improvement and expansion projects. The focus will be on basic track work, the acquisition of new AC locomotives, additions to the car fleet and improvements to yards, information systems and commercial facilities. Capital expenditures in 1998 are expected to be funded largely from existing cash balances, operations and proceeds from line sales.

The Company's continued extensive restructuring and fleet renewal programs will improve customer service, accelerate cost reduction and improve its competitive position. A significant investment in information systems technology will further streamline processes in 1998.

At December 31, 1997, the Company had committed to future capital expenditures amounting to $563.9 million. Of this amount, $529.9 million relates to agreements entered into during 1997 for 172 high-horsepower, high-adhesion AC locomotives. Of these, 91 units representing $284.6 million in capital commitments are scheduled for delivery in 1998, and 81 units representing $245.3 million in capital commitments are scheduled for delivery in 1999.

With respect to existing lease commitments, minimum lease payments in 1998 will total $162.8 million.

The Company's traffic volumes and revenues are largely dependent upon the health and growth of the North American economy. The railway is particularly sensitive to factors affecting Canada's agricultural, mining, forest products and automotive sectors. The volume of export and import traffic is subject to a range of external influences, including the growth of the economies of Canada, the U.S. and key importing countries, as well as exchange rates and other factors affecting the volume and direction of international trade. In addition, agricultural traffic is heavily influenced by weather conditions in Canada, the U.S. and other producing countries. The majority of these factors are beyond the influence or control of the railway industry. The Company faces intense competition from other railways and from highway carriers. It also has a substantial investment in fixed plant and equipment and has limited flexibility to adjust output levels and expenditures in response to short term declines in traffic. Inefficient asset utilization during periods of reduced demand, combined with intense competition, could have an adverse impact on earnings levels. Such a situation could persist until the external economic environment prompts a recovery in traffic levels.

The Company has addressed issues relating to continued operations of its information technology systems in the Year 2000 and has in place a coordinated company-wide plan to ensure business operations are not interrupted. The Company's senior management has created a core team to oversee implementation of the Year 2000 Readiness Plan. During 1997, an examination was begun of all existing systems and devices to identify those that affect essential business processes and use date data. These key systems were then assessed to determine whether they meet Year 2000 requirements. Correction of deficiencies will take place during 1998 to allow final testing and verification during 1999. In addressing Year 2000 issues, $4 million was spent during 1997 and $30 million is forecast to be spent during the 1998-1999 period.

Labour relations

National agreements were achieved in 1997 with three of seven bargaining units in Canada through direct negotiations.

Two-year collective agreements expiring at the end of 1998 were reached with the Transportation-Communications International Union, representing clerical workers, and the International Brotherhood of Electrical Workers, representing signals and communications employees. These agreements provide for wage increases of two per cent for each of 1997 and 1998. In addition to a gain-sharing provision to drive productivity improvements, there are also improvements in health and vision plans, pensions and life insurance. The contracts also provide the Company with a greater degree of work-rule flexibility in such areas as cross-crafting and scheduling.

A one-year collective agreement expiring at the end of 1998 was reached with the Canadian Council of Railway Operating Unions ("CCROU"), representing train service employees. This agreement was negotiated in lieu of arbitration of an outstanding issue from the 1995 negotiating process concerning the minimum work day. The agreement included: a one-year wage freeze; a new method of pay; the reduction of restrictive work rules; a gain-share program that permits employees to share in the benefits of improved productivity; and a commitment to improve the quality of life for employees and the operational safety of trains.

A national agreement with the Rail Canada Traffic Controllers union expired at the end of 1996. National agreements with the National Automobile, Aerospace, Transportation & General Workers Union of Canada ("CAW"), representing mechanical services employees, the Brotherhood of Maintenance of Way Employees ("BMWE"), representing track maintenance workers, and the Canadian Pacific Police Association expired at the end of 1997. At the beginning of February 1998, the Company was in open negotiations with three of the above unions. The BMWE, which had given notice to the Minister of Labour that the parties had reached an impasse in their negotiations, is in ongoing conciliation with the Company under the Canada Labour Code. The major issues with all four unions are workforce flexibility, cost reduction and productivity improvement.

In June 1997, the Company entered into an internal shortline agreement with the CCROU covering a marginally economic branch line in southeastern British Columbia. The agreement improves labour flexibility and alters pay schedules for employees, giving the Company the option of retaining the line rather than selling it to an external operator. Employees and their unions benefit through continued employment with the Company.

In the U.S., the Company is party to collective agreements with 31 bargaining units: 16 with the Soo Line Corporation ("Soo Line") and 15 with the Delaware and Hudson Railway Company ("D&H").

During the summer of 1996, industry-wide bargaining resulted in a five-year settlement retroactive to January 1995 and expiring in December 1999. These national agreements produced end rate increases ranging from 14.7 per cent to 19 per cent. Several also contained work-rule changes that will further increase ongoing annual costs.

Neither the Soo Line nor the D&H participated in the industry-wide negotiations. Instead, they began negotiating with local units of the unions to achieve settlements more tailored to their needs. On the Soo Line, agreements have been reached with 10 bargaining units representing almost two-thirds of unionized employees. Four-year collective agreements expiring at the end of 1998 have been reached with unions representing car shop foremen and signal maintainers. Five-year collective agreements

expiring at the end of 1999 have been reached with unions representing track maintenance employees, clerical staff, train dispatchers, machinists and electricians, as well as with three unions representing car shop employees. All of the agreements include work-rule changes that are expected to increase flexibility. Several also include processes for joint union-management cooperation.

On the D&H, a four-year collective agreement expiring at the end of 1998 was reached with the Brotherhood of Locomotive Engineers. This agreement provides for a trip rate pay system, lump sum payments and wage increases conditional on operating improvements.

Other U.S. agreements have been open and subject to negotiation since 1995. At the beginning of February 1998, negotiations with four bargaining units on the Soo Line and three on the D&H were in mediation. The Company is unable to predict the outcome of these negotiations.

Regulation

In April 1997, the Canadian Wheat Board filed a complaint with the Canadian Transportation Agency ("CTA") alleging that Canadian Pacific Railway and another major Canadian railway had failed to fulfill their service obligations pursuant to the CTA for receiving, carrying and delivering wheat and barley to different destinations from December 1996 to June 1997. The Board alleged that this had cost it and farmers more than $50 million in increased expenses and reduced revenues, excluding general damages, and had damaged the Board's reputation. The Board seeks an order that the railways were in neglect of their duty and that they must provide reasonable and suitable accommodation for the transportation of grain. The Company denies the grounds for the Board's application and is mounting a vigorous defence on the basis that it fully met its service obligations, despite extremely adverse weather and related conditions. The CTA has scheduled a hearing on the Board's application to begin on March 30, 1998.

Environmental protection

Through an Environmental Protection Policy instituted in 1990, the Company ensures that its environmental policies and procedures meet ongoing needs. Actions taken during 1997 included site investigation and remediation, as well as waste disposal and facility improvements.

Based on environmental investigations at various sites across Canada and the U.S., the Company recorded a charge to earnings in 1995 to cover the cost of an environmental remediation program over the next 10 years. Sites were classified according to their known environmental conditions as well as their past use and level of railway activity. In 1997, the provision was extended to cover the program until 2007.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The information in this Annual Report is the responsibility of management. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and include some amounts based on management's best estimates and careful judgment.

Management maintains a system of internal accounting controls to provide reasonable assurance that assets are safeguarded and that transactions are authorized, recorded and reported properly. The internal audit department reviews these accounting controls on an ongoing basis and reports its findings and recommendations to management and the Audit Committee of the Board of Directors.

The Board of Directors carries out its responsibility for the consolidated financial statements principally through its Audit Committee, consisting of four members, all of whom are outside directors. This Committee reviews the consolidated financial statements with management and the independent auditors prior to submission to the Board for approval. It also reviews the recommendations of both the independent and internal auditors for improvements to internal controls, as well as the actions of management to implement such recommendations.

G.C. Halatsis
Executive Vice-President and
Chief Financial Officer

R.J. Ritchie
President and
Chief Executive Officer

February 6, 1998

AUDITORS' REPORT

To the Shareholder of Canadian Pacific Railway Company

We have audited the consolidated balance sheets of Canadian Pacific Railway Company as at December 31, 1997 and 1996, and the consolidated statements of income, retained income and changes in financial position for each of the three years in the period ended December 31, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of Canadian Pacific Railway Company as at December 31, 1997 and 1996, and the results of its operations and the changes in its financial position for each of the three years in the period ended December 31, 1997, in accordance with generally accepted accounting principles in Canada.

Price Waterhouse

Chartered Accountants
Calgary, Alberta

February 6, 1998

STATEMENT OF CONSOLIDATED INCOME

Year ended December 31 (in millions)	**1997**	1996	1995
Railway			
Revenues			
Freight	**$ 3,428.7**	$ 3,379.3	$ 3,408.6
Other	**288.1**	180.1	151.6
	3,716.8	3,559.4	3,560.2
Operating expenses			
Engineering	**286.0**	315.0	357.6
Mechanical	**424.1**	419.9	438.8
Transportation	**1,338.9**	1,308.2	1,365.8
General and administrative (Note 4)	**616.6**	685.5	1,852.3
Depreciation and amortization	**249.1**	226.2	241.0
	2,914.7	2,954.8	4,255.5
Operating income (loss)	**802.1**	604.6	(695.3)
Other (income) charges (Note 6)	**44.2**	(44.6)	62.2
Interest expense (Note 7)	**119.8**	112.9	101.8
Income tax expenses (recovery) (Note 8)	**171.6**	90.0	(303.6)
Net income (loss) – railway	**466.5**	446.3	(555.7)
Non-rail			
Other (income) charges (Note 6)	**0.6**	(3.0)	(44.8)
Interest income (Note 7)	**(23.8)**	(59.3)	(72.5)
Income tax expense (Note 8)	**20.8**	20.5	17.1
Net income – non-rail	**2.4**	41.8	100.2
Net income (loss)	**$ 468.9**	$ 488.1	$ (455.5)

CONSOLIDATED BALANCE SHEET

December 31 (in millions)	1997	1996
Assets		
Current assets		
Cash and short term investments	**$ 462.0**	$ 340.2
Accounts receivable (Note 9)	**402.0**	377.0
Advances to affiliate	**–**	412.0
Materials and supplies	**173.0**	188.2
Deferred income taxes	**75.4**	89.8
Other current assets	**108.3**	85.5
	1,220.7	1,492.7
Long term loans to affiliates	**–**	47.7
Investments (Note 12)	**165.0**	700.4
Net properties (Note 13)	**6,176.3**	5,837.3
Other assets and deferred charges (Note 14)	**280.3**	259.8
Total assets	**$ 7,842.3**	$ 8,337.9
Liabilities and shareholder's equity		
Current liabilities		
Bank loan	**$ –**	$ 95.9
Accounts payable and accrued liabilities	**1,227.6**	987.3
Income and other taxes payable	**93.0**	69.5
Long term debt maturing within one year (Note 15)	**25.0**	18.9
Other current liabilities	**152.6**	149.6
	1,498.2	1,321.2
Deferred liabilities (Note 16)	**564.8**	784.6
Long term debt (Note 15)	**1,375.9**	1,319.0
Advances from affiliate (Note 21)	**305.2**	–
Deferred income taxes	**759.7**	548.7
Deferred income credits (Note 17)	**498.1**	516.0
Shareholder's equity (Note 18)		
Ordinary shares	**1,804.5**	738.9
Premium on securities	**276.4**	276.4
Foreign currency translation adjustments	**79.0**	87.6
Retained income	**680.5**	2,745.5
	2,840.4	3,848.4
Total liabilities and shareholder's equity	**$ 7,842.3**	$ 8,337.9

Approved on behalf of the Board:

D.P. O'Brien, *Director*

S.A. Milner, *Director*

STATEMENT OF CHANGES IN CONSOLIDATED FINANCIAL POSITION

Year ended December 31 (in millions)

	1997	1996	1995
Operating activities			
Net income (loss) – railway	**$ 466.5**	$ 446.3	$ (555.7)
Depreciation and amortization	**249.9**	226.4	241.3
Deferred income taxes	**203.8**	83.2	(312.0)
Gain on redemption of Perpetual 4% Consolidated Debenture Stock	**–**	(120.4)	–
Restructuring costs and write-down of assets (Note 4)	**(1.6)**	29.5	1,143.0
Amortization of exchange losses and discount on restructuring accruals	**27.7**	34.9	51.0
Cash flow	**946.3**	699.9	567.6
Restructuring payments	**(209.4)**	(216.2)	(124.3)
Other operating activities, net	**(105.7)**	(62.4)	23.9
Change in non-cash working capital items (Note 10)	**106.9**	(160.9)	(11.3)
Cash from railway operating activities	**738.1**	260.4	455.9
Cash from non-rail operating activities (Note 11)	**9.9**	124.7	29.1
Total cash from operating activities	**748.0**	385.1	485.0
Dividends paid			
Assets distributed to parent in form of dividend	**(1,485.1)**	(1.2)	(30.3)
Less: Non-cash component of assets distributed	**762.8**	–	–
Cash dividends	**(722.3)**	(1.2)	(30.3)
Investing activities			
Additions to properties	**(862.9)**	(567.0)	(774.1)
Government and external programs	**4.9**	20.7	66.5
Cash capital program	**(858.0)**	(546.3)	(707.6)
Other investments	**(25.9)**	(18.1)	(22.2)
Net proceeds from disposal of transportation properties and investments	**451.9**	19.5	25.9
Increase in accounts payable resulting from additions to properties	**221.1**	–	–
Total railway investing activities	**(210.9)**	(544.9)	(703.9)
Total non-rail investing activities (Note 11)	**(30.0)**	131.1	276.1
Total investing activities	**(240.9)**	(413.8)	(427.8)
Financing activities			
Issuance of long term debt	**7.6**	7.0	203.3
Contribution from affiliate	**–**	57.4	–
Repayment of long term debt	**(16.9)**	(13.6)	(61.0)
Redemption of Perpetual 4% Consolidated Debenture Stock	**–**	(105.9)	–
Advances from affiliate	**305.2**	–	–
Advances from (to) parent	**137.0**	(412.0)	–
Total financing activities	**432.9**	(467.1)	142.3
Cash position*			
Increase (decrease) in cash	**217.7**	(497.0)	169.2
Cash at beginning of year	**244.3**	741.3	572.1
Cash at end of year	**$ 462.0**	$ 244.3	$ 741.3

* Cash and cash equivalents comprises cash or short term investments net of bank loans.

STATEMENT OF CONSOLIDATED RETAINED INCOME

Year ended December 31 (in millions)

	1997	1996	1995
Balance, January 1, as previously reported	**$ 2,422.3**	$ 2,670.3	$ 3,192.7
Prior period adjustment (Note 3)	**323.2**	282.3	245.7
Balance, January 1, as restated	**2,745.5**	2,952.6	3,438.4
Net income (loss) for the year	**468.9**	488.1	(455.5)
Capitalization of retained income into ordinary shares (Note 18)	**(1,065.6)**	–	–
Impact of conversion of Fourth Preferred Shares for Laidlaw	**16.8**	–	–
Transfer of economic interest in Laidlaw to parent (Note 18)	**–**	(694.0)	–
Dividends paid			
Ordinary shares	**(16.0)**	(1.2)	(30.3)
Distribution to parent (Note 1)	**(1,469.1)**	–	–
Balance, December 31	**$ 680.5**	$ 2,745.5	$ 2,952.6

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Corporate reorganization

As part of a corporate reorganization on July 4, 1996, Canadian Pacific Limited changed its name to Canadian Pacific Railway Company ("the Company") and became a subsidiary of a newly created publicly held Canadian Pacific Limited ("CPL"). The Company then distributed its interest in non-rail industries, with a few exceptions, to CPL. Immediately following the reorganization, the Company was comprised of the former railway division of CPL, interests in Laidlaw Inc. and in a number of other non-rail companies largely set up as international financing vehicles for the railway and a number of other non-strategic assets.

In June of 1997, the Company distributed to CPL $1.469 billion of its non-strategic assets comprising the bulk of its non-rail segment.

2. Summary of significant accounting policies

In order to present meaningful comparative annual financial information for periods prior to the reorganization described in Note 1, the financial statements of the Company are presented as though the transfer of assets to CPL in connection with the July 4, 1996, reorganization had taken place prior to January 1, 1995, except for the treatment of the railway's interest expense as explained in Note 7.

Principles of consolidation

These consolidated financial statements include adjustments (see Note 3) to better reflect an accounting basis that is more comparable with that employed by other Class I railroads in North America. The unconsolidated books and records of the railway entities within the consolidated group continue to be reported according to generally accepted accounting practices for railways as set forth in regulations by the Canadian Transportation Agency in Canada and by the Surface Transportation Board in the United States.

The following list sets out the Company's principal subsidiaries, including the jurisdiction of incorporation and the percentage of voting securities owned directly or indirectly by the Company as of the date hereof.

Principal subsidiary	Incorporated under the laws of	Percentage of voting securities held directly or indirectly by the Company
Soo Line Corporation ("Soo Line")	Minnesota	100%
Delaware and Hudson Railway Company, Inc. ("D&H")	Delaware	100%
St. Lawrence and Hudson Railway Company Limited ("StL&H")	Canada	100%

Revenue recognition

Railway freight revenues are recognized based on the percentage-of-completion method. This accounting policy represents a change from prior years when freight revenues were recognized upon the completion of movements. The result of this change was not material to the financial statements and was applied prospectively, beginning in 1997.

Foreign currency translation

Foreign currency assets and liabilities of the Company's operations, other than through foreign subsidiaries, are translated into Canadian dollars at the year-end exchange rate for monetary items and at the historical exchange rates for non-monetary items. Foreign currency revenues and expenses are translated at the exchange rate in effect on the dates of the related transactions. With the exception of unrealized gains and losses on long term monetary assets and liabilities, which are being amortized to income over the remaining lives of the related items, foreign currency gains and losses are included immediately in income.

The accounts of the Company's foreign subsidiaries are translated into Canadian dollars using the year-end exchange rate for assets and liabilities and the average exchange rates in effect for the year for revenues and expenses. Exchange gains or losses arising from translation of foreign subsidiaries' accounts are included under Shareholder's equity as foreign currency translation adjustments. Also included as a foreign currency translation adjustment is the exchange credit arising from translation of the Company's Perpetual 4% Consolidated Debenture Stock.

Post-retirement benefits

Pension costs are actuarially determined on the basis of management's best estimates using the projected benefit method prorated over the service lives of employees. Pension expense includes the cost of pension benefits earned by employees during the current year and the amortization of adjustments arising from pension plan amendments, from experience gains and losses and from changes in assumptions. The amortization period covers the expected average remaining service lives of employees covered by the plan. The difference between the market-related value of the pension fund assets and the present value of accrued pension benefits at the date the present accounting policy was adopted is also being amortized over the expected average remaining service lives of plan employees.

For post-retirement health care and life insurance benefits, costs are based on the annual insurance premium paid to provide these benefits.

Materials and supplies

Inventories of materials and supplies are valued at the lower of average cost and replacement value.

Properties

Fixed asset additions and major renewals are recorded at cost. All labour, material and overheads for programmed track replacement are now capitalized (see Note 3). Computer system development costs on major new systems are capitalized. When depreciable property is retired or otherwise disposed of in the normal course of business, the book value, less salvage, is charged to accumulated depreciation.

Depreciation is calculated on the straight-line basis at rates based upon the estimated service life taking into consideration the projected annual usage of depreciable property, except for rail and other track material in the United States, which is based directly on usage.

Equipment under capital lease is included in properties and depreciated over the period of expected use. Estimated service life used for principal categories of properties is as follows:

Assets	Years
Diesel locomotives	27 to 50
Freight cars	22 to 42
Ties	28 to 57
Rails	
– in first position	19 to 23
– in other than first position	27 to 62
Computer system development costs	5 to 10

Restructuring charges

The present values of future payments toward the accrued restructuring charges as well as the undiscounted environmental remediation accrual are recorded in deferred liabilities and in accrued liabilities. The discount is being amortized over the payment period.

3. Change in accounting policies

In order to make the Company's consolidated results more comparable with other North American railways the Company is presenting in 1997, on a retroactive basis, new capitalization and reporting policies. A significant component of the change in the consolidated reporting is the capitalization of all expenditures associated with the programmed replacement of track and structures, some of which were previously expensed. Also, the Company began netting expenses and revenues related to certain ancillary activities such as switching, cartage and passenger services. Netting will not have an effect on reported income but has been applied to comparative data for previous years to make it more consistent with the presentation adopted for 1997. The Company has also recognized revenues on a percentage-of-completion basis which were previously recognized on a completed basis. The result of this latter change is not material and has been applied prospectively, commencing in 1997.

For the year ended December 31 (in millions)

	1997	1996	1995
Increase in net properties	**$ 124.1**	$ 74.9	$ 66.5
Increase in deferred income taxes	**(54.8)**	(34.0)	(29.9)
Impact on reported net income	**$ 69.3**	$ 40.9	$ 36.6

As at January 1 (in millions)

	1997	1996	1995
Cumulative impact on net properties	**$ 590.0**	$ 515.1	$ 448.6
Cumulative impact on deferred income taxes	**(266.8)**	(232.8)	(202.9)
Cumulative prior period adjustment	**$ 323.2**	$ 282.3	$ 245.7

4. Restructuring charges

In 1995, the Company announced a major reorganization and recorded a restructuring charge in general and administrative expenses totalling $1.143 billion.

5. Segmented information

(in millions)

	Canada	United States	Other Countries	Consolidating Entries	Total
Geographic segments					
1997					
Revenues	**$ 2,737.5**	**$ 966.6**	**$ –**	**$ 12.7**	**$ 3,716.8**
Operating expenses	**2,206.1**	**820.6**	**–**	**(112.0)**	**2,914.7**
Operating income	**531.4**	**146.0**	**–**	**124.7**	**802.1**
Interest and other charges	**161.8**	**34.9**	**(55.9)**	**–**	**140.8**
Income taxes	**114.0**	**18.2**	**3.5**	**56.7**	**192.4**
Net income	**$ 255.6**	**$ 92.9**	**$ 52.4**	**$ 68.0**	**$ 468.9**
Current assets	**$ 779.2**	**$ 495.1**	**$ 3.2**	**$ (56.8)**	**$ 1,220.7**
Long term assets	**4,563.4**	**1,348.3**	**–**	**709.9**	**6,621.6**
Total assets	**$ 5,342.6**	**$ 1,843.4**	**$ 3.2**	**$ 653.1**	**$ 7,842.3**
Current liabilities	**$ 1,196.5**	**$ 361.6**	**$ 1.6**	**$ (61.5)**	**$ 1,498.2**
Long term liabilities	**2,915.5**	**242.3**	**22.7**	**323.2**	**3,503.7**
Shareholder's equity	**1,230.6**	**1,239.5**	**(21.1)**	**391.4**	**2,840.4**
Total liabilities and shareholder's equity	**$ 5,342.6**	**$ 1,843.4**	**$ 3.2**	**$ 653.1**	**$ 7,842.3**
1996					
Revenues	$ 2,499.9	$ 1,059.5	$ –	$ –	$ 3,559.4
Operating expenses	2,236.5	793.2	–	(74.9)	2,954.8
Operating income	263.4	266.3	–	74.9	604.6
Interest and other charges	15.2	51.3	(60.5)	–	6.0
Income taxes	76.5	(3.9)	3.9	34.0	110.5
Net income	$ 171.7	$ 218.9	$ 56.6	$ 40.9	$ 488.1
Current assets	$ 837.1	$ 422.5	$ 314.6	$ (81.5)	$ 1,492.7
Long term assets	4,127.9	1,519.4	607.9	590.0	6,845.2
Total assets	$ 4,965.0	$ 1,941.9	$ 922.5	$ 508.5	$ 8,337.9
Current liabilities	$ 898.6	$ 500.6	$ 3.5	$ (81.5)	$ 1,321.2
Long term liabilities	2,501.6	369.2	30.7	266.8	3,168.3
Shareholder's equity	1,564.8	1,072.1	888.3	323.2	3,848.4
Total liabilities and shareholder's equity	$ 4,965.0	$ 1,941.9	$ 922.5	$ 508.5	$ 8,337.9

(in millions)

	Canada	United States	Other Countries	Consolidating Entries	Total
Geographic segments					
1995					
Revenues	$ 2,454.7	$ 1,105.5	$ –	$ –	$ 3,560.2
Operating expenses	2,927.9	1,394.1	–	(66.5)	4,255.5
Operating income	(473.2)	(288.6)	–	66.5	(695.3)
Interest and other charges	100.1	38.2	(91.6)	–	46.7
Income taxes	(244.6)	(77.1)	5.3	29.9	(286.5)
Net income (loss)	$ (328.7)	$ (249.7)	$ 86.3	$ 36.6	$ (455.5)
Current assets	$ 881.3	$ 524.7	$ 15.4	$ (67.8)	$ 1,353.6
Long term assets	4,738.6	1,349.5	1,199.1	515.1	7,802.3
Total assets	$ 5,619.9	$ 1,874.2	$ 1,214.5	$ 447.3	$ 9,155.9
Current liabilities	$ 869.1	$ 413.9	$ 7.8	$ (67.8)	$ 1,223.0
Long term liabilities	2,566.8	437.9	589.8	232.8	3,827.3
Shareholder's equity	2,184.0	1,022.4	616.9	282.3	4,105.6
Total liabilities and shareholder's equity	$ 5,619.9	$ 1,874.2	$ 1,214.5	$ 447.3	$ 9,155.9

The condensed income statement and balance sheet for the Canadian segment have been prepared in accordance with the Uniform Classification of Accounts issued by the Canadian Transportation Agency in Canada. The changes required to consolidate the Canadian segment are identified above as consolidating entries with the exception of amounts adjusting current assets and liabilities which are eliminations of inter-segment balances.

The Company operates in only one business segment, rail transportation. During the year, the Company effectively transferred all remaining non-rail holdings to its parent.

(in millions)

	1997	1996	1995
Business segments			
Railway			
Identifiable assets	**$ 7,842.3**	$ 7,268.4	$ 6,467.0
Non-rail holdings			
Identifiable assets	**$ –**	$ 1,836.7	$ 2,592.8
Summary			
Identifiable assets	**$ 7,842.3**	$ 9,105.1	$ 9,059.8
Investment in Laidlaw Inc.	**–**	–	694.0
Inter-company eliminations	**–**	(767.2)	(597.9)
	$ 7,842.3	$ 8,337.9	$ 9,155.9

6. Other (income) charges

(in millions)

	1997	1996	1995
Gain on partial redemption of Perpetual 4% Consolidated Debenture Stock	**$ –**	$ (120.4)	$ –
Amortization of discount on restructuring accruals	**21.0**	31.2	40.4
Adjustment of discount on restructuring accruals	**9.7**	30.0	–
Amortization of foreign exchange losses on long term debt	**6.7**	3.7	10.6
Other exchange losses	**6.8**	9.0	–
Real estate income	**(0.9)**	(1.1)	(1.1)
Charges on sale of accounts receivable	**1.8**	2.5	5.3
Loss on early redemption of debt	**–**	–	7.0
Other railway items	**(0.9)**	0.5	–
Non-rail (income) loss	**0.6**	(3.0)	(44.8)
	$ 44.8	$ (47.6)	$ 17.4

7. Interest expense

To segregate non-rail interest income from ongoing railway activities, inter-segment interest has not been netted in the segmented components of the income statement. However, the following table shows interest income and expense net of inter-segment interest.

(in millions)

	1997	1996	1995
Interest on long term debt and debenture stock	**$ 120.1**	$ 85.3	$ 66.9
Interest income	**(24.1)**	(31.7)	(37.6)
	$ 96.0	$ 53.6	$ 29.3

Interest expense in 1995 and in the first six months of 1996 was based on the debt structure of the railway and non-rail entities prior to the reorganization on July 4, 1996. Interest expense for the second half of 1996 and the first half of 1997 reflects the debt structure that was put in place as part of the 1996 corporate reorganization. As the non-rail segment was effectively transferred to CPL in June 1997, there is no further interest income relating to that segment from that date.

Interest received from and paid to affiliates during 1997 was $3.8 million and $9.1 million (1996 – $8.4 million and $3.1 million; 1995 – $17.7 million and $5.3 million), respectively.

8. Income tax expense (recovery)

The following summarizes the Company's tax provisions:

(in millions)

	1997	1996	1995
Canada			
Current	**$ (40.2)**	$ 6.6	$ 8.0
Deferred	**230.9**	103.9	(222.1)
	190.7	110.5	(214.1)
Foreign			
Current	**10.1**	4.8	6.3
Deferred	**(8.4)**	(4.8)	(78.7)
	1.7	–	(72.4)
Total			
Current	**(30.1)**	11.4	14.3
Deferred	**222.5**	99.1	(300.8)
	$ 192.4	$ 110.5	$ (286.5)

The deferred income tax expense (recovery) arose from the following:

(in millions)

	1997	1996	1995
Excess of tax over book depreciation	**$ 117.6**	$ 69.1	$ 60.8
Losses tax-affected	**–**	–	(6.8)
Tax losses utilized	**58.2**	40.4	54.4
Write-down of assets and restructuring costs	**6.8**	(107.9)	(438.8)
Reduction in restructuring accruals	**54.2**	79.0	35.5
Other	**(14.3)**	18.5	(5.9)
	$ 222.5	$ 99.1	$ (300.8)

The difference between the income tax expense (recovery) and the provision obtained by applying the statutory tax rate is as follows:

(in millions)

	1997	1996	1995
Provision for income taxes at Canadian statutory rate	**$ 297.2**	$ 278.0	$ (360.3)
Increase (decrease) in taxes resulting from:			
Large corporations tax	**8.4**	6.5	7.4
Gains not subject to tax	**10.5**	(54.7)	–
Foreign tax rate differences	**(20.7)**	(30.5)	4.7
Tax losses utilized not previously affected	**(110.9)**	(95.0)	52.1
Other	**7.9**	6.2	9.6
Income tax expense (recovery)	**$ 192.4**	$ 110.5	$ (286.5)

9. Sale of accounts receivable

The Company has a securitization agreement involving the sale of accounts receivable which at December 31, 1997, amounted to $110.0 million (1996 – $110.0 million). Cash proceeds on the sale of these receivables were $100.0 million (1996 – $100.0 million) with $10.0 million (1996 – $10.0 million) having been held back as a reserve to be released to the Company upon termination of the agreement.

10. Change in non-cash working capital balances

(in millions)

	1997	1996	1995
Decrease (increase) in current assets			
Accounts receivable	**$ (25.0)**	$ (134.1)	$ 10.0
Materials and supplies	**15.2**	(2.3)	21.4
Other current assets	**(22.8)**	(32.5)	21.4
Increase (decrease) in current liabilities			
Accounts payable and accrued liabilities	**240.3**	2.4	214.1
Income and other taxes payable	**23.5**	55.6	(49.9)
Other current liabilities	**3.0**	(61.2)	(24.4)
Decrease (increase) in non-cash working capital balances	**234.2**	(172.1)	192.6
Increase (decrease) in non-cash working capital balances relating to restructuring costs	**83.5**	61.9	(211.3)
Increase in accounts payable resulting from additions to properties	**(221.1)**	–	–
Other	**0.6**	1.2	–
Decrease (increase) in non-cash working capital balances relating to operations	**$ 97.2**	$ (109.0)	$ (18.7)
Decrease (increase) in railway non-cash working capital balances	**$ 106.9**	$ (160.9)	$ (11.3)
Decrease (increase) in non-rail non-cash working capital balances	**(9.7)**	51.9	(7.4)
	$ 97.2	$ (109.0)	$ (18.7)

11. Cash from (used in) non-rail operating and investing activities

(in millions)

	1997	1996	1995
Cash from non-rail operating activities			
Net income	**$ 2.4**	$ 41.8	$ 100.2
Deferred income taxes	**18.7**	15.9	11.2
Other operating activities, net	**(1.5)**	15.1	(74.9)
Change in non-cash working capital items (Note 10)	**(9.7)**	51.9	(7.4)
Cash from non-rail operating activities	**$ 9.9**	$ 124.7	$ 29.1
Non-rail investing activities			
Non-rail investments	**$ (30.0)**	$ –	$ –
Decrease in long term loans to affiliated companies	**–**	131.1	276.1
Total non-rail investing activities	**$ (30.0)**	$ 131.1	$ 276.1

12. Investments

(in millions)

	1997	1996
Accounted for on an equity basis		
CNCP Niagara-Detroit Partnership	**$ 40.1**	$ 43.3
Other	**43.1**	19.6
Accounted for on a cost basis		
Investments in affiliated companies	**–**	556.8
Other	**81.8**	80.7
	$ 165.0	$ 700.4

In June 1997, investments in an affiliated non-rail company, Canadian Pacific (Bermuda) Ltd., amounting to $556.8 million were distributed to CPL (see Note 1).

13. Net properties

(in millions)

	1997			1996
	Cost	Accumulated depreciation	Net book value	Net book value
Track and roadway	**$ 5,715.1**	**$ 1,933.7**	**$ 3,781.4**	$ 3,840.5
Buildings	**406.6**	**180.4**	**226.2**	210.4
Rolling stock	**2,410.1**	**1,017.1**	**1,393.0**	1,210.6
Other	**1,327.6**	**551.9**	**775.7**	575.8
	$ 9,859.4	**$ 3,683.1**	**$ 6,176.3**	$ 5,837.3

As at December 31, 1997, net properties included assets held under capital lease of $243.9 million at cost (1996 – $257.3 million), and related accumulated depreciation of $51.6 million (1996 – $47.3 million).

14. Other assets and deferred charges

(in millions)

	1997	1996
Prepaid pension costs	**$ 121.7**	$ 110.2
Unamortized exchange loss	**120.7**	102.3
Other	**37.9**	47.3
	$ 280.3	$ 259.8

15. Long term debt

(in millions)

	1997	1996
6.875% Debentures due 2003	**$ 357.5**	$ 342.5
9.450% Debentures due 2021	**357.5**	342.5
8.850% Debentures due 2022	**357.5**	342.5
Obligations under capital leases due 1998 – 2014 (6.85% – 12.7%)	**266.4**	248.0
Other	**2.4**	5.2
	1,341.3	1,280.7
Perpetual 4% Consolidated Debenture Stock	**59.6**	57.2
	1,400.9	1,337.9
Less: Long term debt maturing within one year	**25.0**	18.9
	$ 1,375.9	$ 1,319.0

The Company's debentures are unsecured but carry a negative pledge. The 8.850% debentures are callable starting in 2002 at a premium which declines over time.

The Consolidated Debenture Stock, created by an Act of Parliament of 1889, constitutes a first charge upon and over the whole of the undertaking, railways, works, rolling stock, plant, property and effects of the Company, with certain exceptions. Despite its perpetual nature, the relatively small remaining amount of Consolidated Debenture Stock was included with long term debt to simplify the balance sheet presentation.

Of the total long term debt outstanding, $1,383.9 million (1996 – $1,315.4 million) represents U.S. dollar-denominated borrowings and $13.8 million (1996 – $13.3 million) is denominated in Pounds Sterling.

Annual maturities and sinking fund requirements, excluding those pertaining to capital leases, for each of the five years following 1997 are: 1998 – $0.3 million; 1999 – $0.6 million; 2000 – $0.2 million; 2001 – $0.2 million; 2002 – $0.2 million.

As of December 31, 1997, capital lease obligations included in long term debt above were as follows:

(in millions)	Capital leases
Minimum lease payments in:	
1998	$ 26.1
1999	19.1
2000	17.7
2001	17.7
2002	17.7
Thereafter	430.0
Total minimum lease payments	528.3
Less: Imputed interest	(261.9)
Present value of minimum lease payments	266.4
Less: Current portion	(24.7)
Long term portion of capital lease obligations	$ 241.7

16. Deferred liabilities

(in millions)

	1997	1996
Provision for restructuring and environmental remediation	**$ 628.5**	$ 805.9
Deferred workers' compensation	**150.8**	133.2
Accrued pension and other benefits	**55.4**	48.0
Due to an affiliate	**–**	135.9
Other	**34.6**	32.6
	869.3	1,155.6
Less: Amount payable within one year	**304.5**	371.0
	$ 564.8	$ 784.6

17. Deferred income credits

Deferred income credits include $155.3 million (1996 – $161.1 million) from the Federal Government, primarily for the rehabilitation of certain western branch lines; $217.4 million (1996 – $215.0 million) from other bodies, mainly for relocation of railway lines; $61.2 million (1996 – $63.7 million) in investment tax credits; $51.7 million (1996 – $57.3 million) in surplus accumulated depreciation; and $12.5 million (1996 – $18.9 million) of other items.

These amounts are being amortized to income on the same basis as the related properties are being depreciated.

18. Shareholder's equity

Authorized and issued share capital

The Company's authorized and issued share capital is as follows:

(in millions)

		1997	1996
	Authorized	**Issued**	Issued
Ordinary Shares	Unlimited	**346.6**	142.4
Preference Shares	Not exceeding one-half the aggregate amount of ordinary shares outstanding	**–**	–
First Preferred Shares	Unlimited	**–**	–
Second Preferred Shares	Unlimited	**–**	–
Third Preferred Shares	Unlimited	**–**	2.4
Fourth Preferred Shares	Unlimited	**–**	7.4

Reorganization of share capital

As part of the 1996 corporate reorganization described in Note 1, the outstanding preference shares were converted to ordinary shares. Subsequent to this, a portion of the outstanding ordinary shares were cancelled upon transfer of non-rail assets to the new parent company. In June 1997, the Company capitalized $1,065.6 million of its retained income by reissuing 204.2 million ordinary shares to its parent company, CPL, a similar number of ordinary shares and capital value to that which were cancelled in 1996. The following table shows the effect of these reorganizations on the Company's share capital:

(in millions)

	Ordinary Shares		Preference Shares	
	Number	Amount	Number	Amount
Pre-reorganization				
In issue at January 1, 1996	342.3	$ 1,767.7	14.1	$ 15.7
Issued during the period	0.8	16.0	–	–
In issue at July 4, 1996	343.1	1,783.7	14.1	15.7
Reorganization				
Conversion of Preference Shares	3.3	15.7	(14.1)	(15.7)
Conversion of Perpetual 4% Consolidated Debenture Stock	0.2	4.9	–	–
Cancellation of Ordinary Shares	(204.2)	(1,065.4)	–	–
In issue at July 4 and December 31, 1996	142.4	738.9	–	–
Capitalization of retained income	204.2	1,065.6	–	–
In issue at December 31, 1997	346.6	$ 1,804.5	–	$ –

Although the corporate reorganization took place on July 4, 1996, these financial statements have been presented as though that reorganization happened prior to January 1, 1995.

Third Preferred Shares – Series 1

During August 1996, the Company issued 2.4 million Third Preferred Shares – Series 1 equally to three affiliated companies. The aggregate subscriptions were $2.4 billion. The preferred shares paid a dividend at a floating rate equal to three-month bankers' acceptance rate plus 10 basis points. At the same time, the Company also made loans totalling $2.4 billion equally to the three above-mentioned affiliated companies. These loans were due August 7, 2001, and bore a floating rate equal to three-month bankers' acceptance rate plus 5 basis points. During September 1997, these loans were repaid and the Third Preferred Shares redeemed.

(in millions)

	1997	1996
Loans receivable from affiliated companies	$ –	$ 2,400.0
Preferred shares issued to affiliated companies	–	(2,400.0)
	$ –	$ –
Interest income on loans	$ 60.2	$ 31.4
Dividends paid on preferred shares	(61.1)	(31.8)
	$ (0.9)	$ (0.4)

As the Company had the right and intent to set off the loans and the preferred shares on redemption of the preferred shares, these amounts have been netted for financial statement presentation.

Fourth Preferred Shares

During 1996, the Company issued 7.4 million Fourth Preferred Shares to CPL which were exchangeable for the Laidlaw Inc. ("Laidlaw") shares held by the Company or a cash amount equal to the market price of the Laidlaw shares at that time. Dividends on the preferred shares were equal to the dividends received by the Company on its Laidlaw shares. As the Company had transferred its economic interest in the investment in Laidlaw to its parent, the preferred shares and the amount recorded for the investment in Laidlaw were netted for financial statement presentation. During 1997, the Fourth Preferred Shares were redeemed in exchange for the investment in Laidlaw.

Foreign currency translation adjustments

Included in equity are the following cumulative foreign currency translation adjustments:

(in millions)

	1997	1996
Balance, January 1	$ 87.6	$ 194.5
Effect of exchange rate changes on Perpetual 4% Consolidated Debenture Stock	(2.4)	(2.2)
Redemption of Perpetual 4% Consolidated Debenture Stock	–	(101.0)
Impact of conversion of Fourth Preferred Shares for Laidlaw	(16.8)	–
Change in foreign currency translation rates on foreign subsidiaries	10.6	(3.7)
Balance, December 31	$ 79.0	$ 87.6

19. Pensions

The Company has defined benefit plans which provide for pensions based principally on years of service and compensation rates near retirement. Annual contributions to the plans, which are based on an actuarial cost method, are made on the basis of not less than the minimum amounts required by federal or provincial pension supervisory authorities.

Net pension expense amounted to $60.6 million in 1997 (1996 – $77.0 million; 1995 – $71.8 million, excluding a restructuring-related charge of $15.0 million) and includes the following components:

(in millions)

	1997	1996	1995
Actual return on pension fund assets	**$ (541.7)**	$ (685.6)	$ (508.7)
Portion of return on pension fund deferred	**318.2**	395.5	199.0
Expected return on pension fund assets	**(223.5)**	(290.1)	(309.7)
Amortization of discount on obligation	**235.0**	312.5	330.4
Amortization of discount on obligation in excess of expected return on assets	**11.5**	22.4	20.7
Net amortization of prior year deferrals	**31.0**	37.6	33.7
Service cost-benefits in the year	**18.1**	17.0	17.4
Net pension expense	**$ 60.6**	$ 77.0	$ 71.8

The following table sets forth the plans' funded status and the prepaid amounts recognized in the Company's consolidated balance sheet as at December 31:

(in millions)

	1997	1996
Actuarial present value of benefit obligation		
Vested	**$ 4,156.0**	$ 4,145.7
Non-vested	**7.1**	8.0
Accumulated benefit obligation	**4,163.1**	4,153.7
Effect of projected salary increases	**386.1**	381.0
Projected benefit obligation (based on a weighted average discount rate of approximately 8% and a weighted average salary increase of approximately 3%)	**4,549.2**	4,534.7
Pension fund assets at market-related values	**4,598.1**	4,387.6
Pension fund assets greater (less) than projected benefit obligation	**48.9**	(147.1)
Unamortized portion of net obligation at January 1, 1987*	**115.1**	142.1
Unamortized prior services cost*	**113.1**	130.0
Unamortized net gain*	**(166.8)**	(20.0)
Net prepaid pension cost in the consolidated balance sheet	**$ 110.3**	$ 105.0

* Amortized over the expected average remaining service lives of employees (generally 13 years).

Pension fund assets consist primarily of listed stocks and bonds. The assumed weighted average long term rate of return on pension fund assets is approximately 8%.

In addition to pension benefits, the Company provides health care and life insurance benefits for certain retired employees. The cost of providing these benefits is recognized by expensing the annual insurance premiums which in 1997 were $9.5 million (1996 – $6.7 million; 1995 – $5.5 million).

The net prepaid pension cost is included in the following components of the consolidated balance sheet:

(in millions)

	1997	1996
Other assets and deferred charges	**$ 121.7**	$ 110.2
Deferred liabilities	**(8.8)**	(5.2)
Accounts payable and accrued liabilities	**(2.6)**	–
	$ 110.3	$ 105.0

20. Financial instruments

Forward foreign currency exchange contracts

Exposure to changes arising from fluctuations in exchange rates between Canadian and U.S. dollars on future revenue streams and certain U.S. dollar expenditures has been managed by selling or purchasing forward U.S. dollars at fixed rates in future periods. As at December 31, 1997, the Company had entered into foreign exchange contracts to sell approximately US$420.0 million at exchange rates ranging from 1.40 to 1.43 over the years 1998 to 2000; and contracts to purchase approximately US$30.0 million in 1998 at a rate of 1.44. As at December 31, 1997, the unrealized loss on forward foreign currency exchange contracts was $2.5 million.

Interest rate swaps

The Company is party to a number of interest rate swap agreements which convert a portion of its fixed interest rate liability into a variable rate liability. As at December 31, 1997, the Company had outstanding swap agreements for nominal amounts of US$295.0 million (equivalent to Cdn.$421.9 million) and Cdn.$37.5 million.

The following table discloses the terms of the swap agreements in place at December 31, 1997:

Expiration	April 1999	June 2002	November 2003
Notional amount of principal *(in millions)*	$ US 195.0	$ US 100.0	$ CDN. 37.5
Fixed receiving rate	7.5%	7.7%	7.9%
Variable paying rate	5.8% (1)	5.9% (1)	6.3% (2)

(1) Based on US LIBOR.

(2) Based on Bankers' Acceptances.

Credit risk management

The Company is exposed to credit losses in the event of non-performance by counterparties to financial instruments, however, the Company does not anticipate such non-performance as dealings have been with counterparties of high credit quality. In addition, the Company believes there are no significant concentrations of credit risk.

Interest rate exposure and fair values

The Corporation's exposure to interest rate risk along with the total carrying amounts and fair values of its financial instruments is summarized in the following table:

	At Floating	Fixed Interest Rate Maturing in			Total	
	Interest	Less Than	One to	More Than	Carrying	
(in millions)	Rates	One Year	Five Years	Five Years	Value	Fair Value
Financial Assets						
Cash and short term investments	$ 462.0	$ –	$ –	$ –	$ 462.0	$ 462.0
Financial Liabilities						
Advances from affiliates	305.2	–	–	–	305.2	305.2
Debentures	–	–	–	1,072.5	1,072.5	1,217.3
4% Consolidated Debenture Stock	–	–	–	59.6	59.6	34.9
Obligations under capital leases	–	24.7	60.7	181.0	266.4	273.1
Other	–	0.3	1.2	0.9	2.4	2.5
Interest rate swaps	459.4	–	(421.9)	(37.5)	–	15.0
Forward foreign currency contracts	–	–	–	–	–	(2.5)

The Company has determined the estimated fair value of its financial instruments based on appropriate valuation methodologies. However, considerable judgment is necessary to develop these estimates. Accordingly, the estimates presented herein are not necessarily indicative of what the Company could realize in a current market exchange. The use of different assumptions or methodologies may have a material effect on the estimated fair value amounts.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

- Short term financial assets and liabilities are valued at their carrying amounts as presented in the balance sheet, which are reasonable estimates of fair value due to the relatively short period to maturity of these instruments.
- Advances from affiliates are valued at their carrying amounts as presented in the balance sheet, which are reasonable estimates of fair value due to the floating rate nature of interest charges.
- The fair value of publicly traded long term debt is determined based upon market prices at December 31, 1997. The fair value of other long term debt is estimated based on rates currently available to the Company for long term borrowing with similar terms and conditions to those borrowings in place at the balance sheet date.
- The fair value of derivative instruments is estimated as the unrealized gain or loss calculated based on market prices or rates at December 31, 1997, which generally reflect the estimated amounts that the Company would receive or pay to terminate the contracts at the balance sheet date.

21. Related party transactions

Rail services provided to affiliated companies yielded revenues in 1997 of $454.1 million (1996 – $427.1 million; 1995 – $374.9 million). Included in accounts receivable is $17.1 million (1996 – $21.9 million) due from affiliates. Included in other current assets is $25.5 million due from affiliates. Cash includes $171.0 million (1996 – $237.8 million) on deposit with affiliated companies. Long term advances from affiliates are repayable at the option of the Company and carry an interest rate of bankers' acceptance plus 0.25 per cent.

22. Commitments

At December 31, 1997, the Company had committed to future capital expenditures amounting to $563.9 million. Of this amount, $529.9 million relates to agreements entered into during 1997 for the construction and delivery of high-horsepower, high-adhesion AC locomotives. Ninety-one units representing $284.6 million of commitments are scheduled for delivery in 1998, and 81 units representing $245.3 million of capital commitments are scheduled for delivery in 1999.

Minimum payments under operating leases were estimated at $675.9 million in aggregate, with annual payments (in millions) in each of the five years following 1997 of: 1998 – $162.8; 1999 – $126.2; 2000 – $86.6; 2001 – $65.8; 2002 – $55.7.

D&H carries a US$35.0-million General Mortgage Indenture with the United States Federal Railroad Administration (FRA). D&H has agreed not to dispose of more than one-third of its mainline route miles for a 10-year term ending in 2001. Non-performance under the terms of this agreement would result in a fine of US$35.0 million payable to the FRA.

23. Reclassification

Certain prior years' figures have been reclassified to conform with the presentation adopted for 1997.

24. Supplementary data

The discussion of Canadian and United States accounting principles and the reconciliation of net income between United States and Canadian generally accepted accounting principles for the years included in Supplementary Data are an integral part of these financial statements.

Canadian and United States accounting principles

The consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles (GAAP) in Canada, as promulgated by the Canadian Institute of Chartered Accountants. Over the years, a number of differences have developed between Canadian and United States GAAP. For the information of the Company's United States investors, the major differences are described below.

Capitalization of interest

The Company follows Canadian GAAP in the expensing of interest related to capital projects undertaken during the year. United States GAAP requires some of these interest costs to be capitalized.

Post-retirement benefits

The Company follows the Canadian practice of expensing costs related to post-retirement health care and life insurance benefits when they are paid, whereas under the United States accounting standard, these costs, based on the terms of the plan, are recognized on an accrual basis during the years the plan participants provide the services.

Pension cost

The principal difference between Canadian and United States GAAP in accounting for pension costs is in the choice of discount rate used for computing the benefit obligation and the service and interest components of net periodic pension expense. Under Canadian GAAP, the discount rate used represents management's best estimate of the long term rate of return on pension fund assets. Under United States GAAP, the discount rate reflects the rate at which pension benefits can be effectively settled at the date of the financial statements.

Foreign exchange gains and losses

The Company follows the Canadian practice of deferring and amortizing unrealized exchange gains and losses related to long term foreign currency assets and liabilities, whereas under United States GAAP such gains and losses are included immediately in income.

Income taxes

The Company follows the Canadian method of accounting for income taxes, described as the deferral method, focusing on differences arising between financial statement income and taxable income. The method followed under United States GAAP, described as the liability method, focuses on differences between the book and tax values of assets and liabilities. In Canada, income taxes are recorded using tax rates and regulations applicable in the current year and are not changed in future years, even though tax rates and regulations may change. In the United States, the tax liability is calculated using enacted future tax rates and regulations and is adjusted in future years if those tax rates and regulations are changed.

Changes in accounting policy

Under Canadian GAAP, the effects of a change in accounting policy are calculated and applied retroactively with prior period amounts being restated to reflect the new policy. Under United States GAAP, the effects of a change in accounting policy are reported in determining the current year's net income with no prior period restatement.

Comparative income statement

A summary of the differences in both operating income and net income resulting from Canadian and United States GAAP is as follows:

(in millions)

	1997	1996	1995
Operating income (loss)			
Canadian GAAP	**$ 802.1**	$ 604.6	$ (695.3)
United States GAAP	**$ 1,424.2**	$ 566.7	$ (815.7)
Net income (loss)			
Canadian GAAP	**$ 468.9**	$ 488.1	$ (455.5)
United States GAAP	**$ 796.8**	$ 486.0	$ (600.5)

Net income is reconciled from Canadian to United States GAAP in the following manner:

(in millions)

	1997	1996	1995
Net income (loss) – Canadian GAAP	**$ 468.9**	$ 488.1	$ (455.5)
Increased (decreased) by:			
Deferred income taxes	**–**	–	(54.6)
Foreign exchange	**(12.0)**	18.9	(24.3)
Pension costs	**25.7**	26.8	(28.1)
Post-retirement benefits	**(3.5)**	(3.6)	(3.1)
Other	**(5.5)**	(3.3)	1.7
Prior period adjustment – Canadian GAAP added to current income (Note 3)	**323.2**	–	–
Reverse restatement due to change in accounting policy (Note 3)	**–**	(40.9)	(36.6)
Net income (loss) – United States GAAP	**$ 796.8**	$ 486.0	$ (600.5)

Balance sheet

Had the consolidated balance sheet been prepared under United States GAAP, the differences would have been as follows (higher/(lower) under United States GAAP):

(in millions)

	1997	1996
Assets		
Properties		
Capitalized interest	**$ 139.8**	$ 150.1
1997 prior period adjustment (Note 3)	**–**	(590.0)
Other assets and deferred charges		
Foreign exchange on long term debt	**(120.7)**	(98.9)
Pension	**(47.6)**	(94.3)
Total assets	**$ (28.5)**	$ (633.1)
Liabilities and shareholder's equity		
Deferred liabilities		
Post-retirement benefit liability	**$ 76.5**	$ 70.2
Deferred income taxes	**(123.8)**	(394.2)
Total liabilities	**(47.3)**	(324.0)
Equity	**18.8**	(309.1)
Total liabilities and shareholder's equity	**$ (28.5)**	$ (633.1)

Statement of changes in financial position

The effect on the statement of changes in consolidated financial position is not significant, except that dividends are treated as a financing activity in the statement of changes in consolidated financial position under United States GAAP.

STATEMENT OF CORPORATE GOVERNANCE PRACTICES

Effective corporate governance calls for the establishment of processes and structures to ensure the sound direction and management of the Company's business with a view to enhancing shareholder value. The Board of Directors believes that the corporate governance practices summarized below are consistent with these objectives.

The Board consists of 16 directors, 14 of whom are unrelated. The related directors are the Chairman of the Board and a director who is counsel to a law firm that provides legal services to the Company. The number of directors constituting the Board has been reduced over the past 12 years from 28 members to its current 16. It is expected that the Board will be further reduced to 15 directors prior to April 21, 1998. The Board believes that this number is appropriate and allows the Board to deliberate effectively.

The Board assumes responsibility for the stewardship of the Company and, in discharging that responsibility, it annually reviews and adopts a long-term strategic plan, an annual financial budget, as well as the consolidated financial statements. It also reviews and, where appropriate, approves major acquisitions and dispositions.

The Executive Committee of the Board is composed of a majority of unrelated directors and, between meetings of the Board, exercises the duties and responsibilities of the Board, except those responsibilities which, by law, only a board of directors may exercise.

The Board has established six other committees to assist it in carrying out its responsibilities.

The Audit Committee consists entirely of unrelated directors. It is responsible for overseeing the Company's internal controls and management information systems, as well as identifying the principal risks of the Company's businesses and the systems in place to manage these risks. The committee also reviews with management and with the internal and external auditors the Company's financial reporting procedures in connection with the annual audit and the preparation of the financial statements.

The Compensation Committee is composed entirely of unrelated directors. It is responsible for recommending to the Board the fees to be paid to directors and the compensation to be paid to management. It also assesses the performance of the Chief Executive Officer and determines his compensation based on the attainment of objectives set by the Board that are consistent with the Company's strategic plan and that are reflected in the performance criteria of the Company's short- and long-term incentive plans.

The Corporate Governance and Nominating Committee is composed entirely of unrelated directors and is charged with responsibility for all matters relating to corporate governance. These responsibilities include recommending candidates for nomination, appointment, election and re-election to the Board and its Committees, assessing Board performance, and determining the most appropriate orientation and education program for new Board members. Directors may, in circumstances considered appropriate by this Committee, engage the services of outside advisers at the Company's expense.

The Environmental and Safety Committee is composed entirely of unrelated directors. It is responsible for making recommendations to the Board on environmental and safety issues and for making reports to the Board on the effectiveness of the Company's response to environmental and safety issues, on the management of risks associated with these issues, and on the implementation of the environmental and safety policy statement adopted by the Board.

The Management Resources Committee, composed entirely of unrelated directors, is responsible for making recommendations to the Board on management succession planning within the Company and its major subsidiaries.

The Pension Trust Fund Committee is composed of a majority of unrelated directors. It is responsible for overseeing the operation and administration of the Company's pension plans and the investment policies and management of the pension trust funds.

The Board of Directors also appreciates the importance of maintaining effective communication with its shareholders. To this end, it reviews the Company's Annual Report, Management's Discussion and Analysis, Annual Information Form, quarterly financial statements, and press releases on major developments before they are distributed. The Company also maintains shareholder and investor relations services to respond to all shareholder inquiries.

FIVE-YEAR SUMMARY

(in millions)

	1997	1996	1995*	1994	1993
Income items					
Revenues	**$ 3,716.8**	$ 3,559.4	$ 3,560.2	$ 3,468.1	$ 3,241.3
Operating expenses by type					
Compensation and benefits	**1,211.2**	1,298.5	1,321.0	1,328.8	1,311.2
Material and other	**1,111.1**	1,105.7	1,228.5	1,224.2	1,085.1
Fuel	**343.3**	324.4	322.0	310.3	290.5
Depreciation	**249.1**	226.2	241.0	237.7	219.0
Total operating expenses	**$ 2,914.7**	$ 2,954.8	$ 3,112.5	$ 3,101.0	$ 2,905.8
Operating income	**$ 802.1**	$ 604.6	$ 447.7	$ 367.1	$ 335.5
Net income from railway	**$ 466.5**	$ 446.3	$ 148.3	$ 98.8	$ 105.9
Other financial highlights					
Operating ratio	**78.4%**	83.0%	87.4%	89.4%	89.6%
Additions to properties	**$ 862.9**	$ 567.0	$ 774.1	$ 420.5	$ 301.4
Total railway assets	**$ 7,842.3**	$ 7,268.4	$ 6,467.0	$ 6,546.4	$ 6,217.6
Net debt:equity of railway	**31:69**	42:58	46:54	35:65	31:69
Number of active employees					
Average for the year	**20,150**	21,728	23,424†	23,887†	24,386
Traffic and operating statistics					
Revenue ton-miles *(in billions)*	**105.8**	103.4	107.0	102.3	93.9
Gross ton-miles *(in billions)*	**186.5**	184.0	192.3	184.9	169.3
Revenue tons carried *(in millions)*	**149.0**	149.2	148.3	141.8	137.4
Gross ton-miles per active employee *(in thousands)*	**9,254**	8,470	8,208	7,739	6,942
Miles of road operated at year-end	**15,865**	17,399	18,064	18,666	19,122
Route miles excluding trackage rights and haulage‡	**12,136**	14,328	15,334	15,973	16,390
Number of locomotives at year-end *(owned and leased)*	**1,619**	1,615	1,665	1,631	1,607
Number of freight cars at year-end *(owned and leased)*	**53,000**	54,000	49,400	48,800	48,400

* Excludes 1995 restructuring charge of $1,143 million ($704 million after tax).

† Adjusted upward to remove impact of 1994 and 1995 strikes, which reduced year average by approximately 300 and 450, respectively.

‡ Excludes miles of road operated under trackage rights and haulage agreements.

DIRECTORS AND OFFICERS

Directors

S.E. Bachand
President and Chief Executive Officer,
Canadian Tire Corporation, Limited
Toronto, Ontario

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President Emeritus,
University of Regina
Regina, Saskatchewan

D. Cohen, C.M., LL.D.(2)(3)(5)
President,
Dian Cohen Productions Ltd.
Ayers Cliff, Quebec

M.J. Fielding(5)
Chairman of the Board,
Alexander Centre Industries Limited
Sudbury, Ontario

A.S. Kingsmill, Q.C.(5)
Counsel,
Law Firm of McCarthy Tétrault
Toronto, Ontario

The Hon. P. Lougheed, P.C., C.C., Q.C.(5)
Partner,
Law Firm of Bennett Jones Verchere
Calgary, Alberta

A.A. MacNaughton(2)(3)(6)
President,
Genstar Investment Corporation
Foster City, California

J.D. McNeil(1)(2)(4)(6)(7)
Chairman and Chief Executive Officer,
Sun Life Assurance Company of Canada
Toronto, Ontario

S.A. Milner, A.O.E., LL.D.(1)(3)(4)(6)(7)
President and Chief Executive Officer,
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Edmonton, Alberta

J.E. Newall, O.C.(2)(3)
Vice-Chairman and Chief Executive Officer,
NOVA Corporation
Calgary, Alberta

D.P. O'Brien(1)(7)
Chairman, President and
Chief Executive Officer,
Canadian Pacific Limited
Calgary, Alberta

J.A. Pattison, O.C.(1)(4)(7)
Chairman, President and
Chief Executive Officer,
Jim Pattison Group Inc.
Vancouver, British Columbia

R.D. Southern, C.M., C.B.E., LL.D.(3)
Chairman and Chief Executive Officer,
ATCO Ltd. and Canadian Utilities Limited
Calgary, Alberta

W.W. Stinson
Chairman, Executive Committee,
United Dominion Industries Limited
Calgary, Alberta

A.R. Taylor, O.C.(1)(4)(6)(7)
Retired Chairman and Chief Executive Officer,
Royal Bank of Canada
Toronto, Ontario

The Rt. Hon. The Viscount Weir(6)
Chairman,
The Weir Group PLC
Glasgow, Scotland

(1) *Member of the Executive Committee*
(2) *Member of the Audit Committee*
(3) *Member of the Compensation Committee*
(4) *Member of the Corporate Governance and Nominating Committee*
(5) *Member of the Environmental and Safety Committee*
(6) *Member of the Management Resources Committee*
(7) *Member of the Pension Trust Fund Committee*

Officers of the Company

W.R. Fatt
Chairman of the Corporation,
Canadian Pacific Railway Company, and
Chairman and Chief Executive Officer,
Canadian Pacific Hotels Corporation

R.J. Ritchie
President and Chief Executive Officer

E.V. Dodge
Executive Vice-President, Operations

G.C. Halatsis
Executive Vice-President and
Chief Financial Officer

J.H. MacDiarmid
Executive Vice-President, Commercial

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